No. 90-516-CFX Title: Jill S. Kamen, Petitioner
Status: GRANTED v.
Kemper Financial Services, Inc., et al.

Docketed: Court: United States Court of Appeals
September 24, 1990 for the Seventh Circuit

Vide: Counsel for petitioner: Meyer,Richard M.

Counsel for respondent: Hall,Joan M., Ruken,Martin M.

Entry	Date	Note	Proceedings and Orders
1	Sep 24 1990	G	Petition for writ of certiorari filed.
2	Oct 19 1990		Brief of respondent Kemper Financial Services, Inc. in opposition filed.
3	Oct 24 1990		DISTRIBUTED. November 9, 1990
4	Nov 2 1990		Reply brief of petitioner Jill Kamen filed.
5	Nov 7 1990		REDISTRIBUTED. November 21, 1990
8	Nov 26 1990		REDISTRIBUTED. November 30, 1990
9	Dec 3 1990		Petition GRANTED. limited to Question 1 presented by the petition.
			**
10	Dec 21 1990		Record filed.
		*	Certified copy of original record and C. A. Proceedings received. (Box).
11	Jan 17 1991		Joint appendix filed.
12	Jan 17 1991		Brief of petitioner Jill Kamen filed.
13	Jan 17 1991		Brief amicus curiae of SEC filed. VIDED.
14	Jan 28 1991	G	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
15	Feb 1 1991		SET FOR ARGUMENT WEDNESDAY, MARCH 27, 1991. (2ND CASE)
16	Feb 19 1991		Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
17	Feb 19 1991		Brief of respondent Cash Equivalent Fund filed.
18	Feb 19 1991	G	Motion of Business Roundtable for leave to file a brief as amicus curiae filed.
19	Feb 19 1991	G	Motion of Investment Company Institute for leave to file a brief as amicus curiae filed.
21	Feb 19 1991	X	Brief of respondent Kemper Financial Services, Inc. filed.
20	Feb 21 1991		CIRCULATED.
22	Mar 4 1991		Motion of Business Roundtable for leave to file a brief as amicus curiae GRANTED.
23	Mar 4 1991		Motion of Investment Company Institute for leave to file a brief as amicus curiae GRANTED.
24	Mar 7 1991	X	Reply brief of petitioner Jill Kamen filed.
25	Mar 27 1991		ARGUED.

(1)

90-516

No. ________

In the

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. As a prerequisite to bringing a shareholder action on behalf of an investment company to recover damages for proxy fraud under Section 20 of the Investment Company Act, must the shareholder first make a demand upon the company's directors to bring the action even where such a demand would be futile?

2. Is there a right to jury trial in a shareholder action for money damages under the Investment Company Act?

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The February 2, 1987 opinion of the District Court for the Northern District of Illinois is reported at 659 F. Supp. 1153. The July 18, 1990 opinion of the Court of Appeals for the Seventh Circuit is reported at [Current Binder] Fed. Sec. L. Rep. (CCH) § 95,363.

JURISDICTION

The decision of the Court of Appeals for the Seventh Circuit was dated and filed on July 18, 1990. Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Seventh Amendment to the United States Constitution provides:

> In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved . . .

Due to their length, Sections 20(a), 36(b) and 44 of the Investment Company Act of 1940, 15 U.S.C. Sections 80a-20(a), 80a-35(b) and 80a-43, and Rule 23.1 of the Federal Rules of Civil Procedure are set forth in the appendix at 96a-100a.

STATEMENT OF THE CASE

Petitioner is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund"), an open-end investment

company or mutual fund registered under the Investment Company Act of 1940. She has brought the action on behalf of the Fund against its investment adviser (the "Adviser").[1]

The action is brought under Sections 20(a) and 36(b) of the Investment Company Act. Section 20(a) proscribes the fraudulent solicitation of proxies with respect to a registered investment company. The complaint herein alleges that the defendant distributed a false and misleading proxy statement which misrepresented comparative fees in order to obtain shareholder approval of its agreement with the Fund.

Section 36(b) provides that the investment adviser of a registered investment company owes it a fiduciary duty with respect to the compensation which the company pays the adviser. For breach of that fiduciary duty, the SEC, or a security holder on behalf of the investment company, may bring suit against the adviser. The complaint alleges that the compensation of the Adviser is excessive resulting in a breach of the Section 36(b) fiduciary duty.

Plaintiff made no pre-suit demand upon the directors to institute or prosecute the action. The complaint sets forth the reasons for not making such a demand. Those reasons are as follows:

> (a) With respect to the claims asserted under Section 36(b) of the Act, no such demand is required.

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[1] *Kamen v. Kemper Financial Services, Inc.*, No. 85 C 4587 (N.D. Ill.). Jurisdiction of the District Court was invoked under Sections 36(b) and 44 of the Act, 15 U.S.C. Sections 80a-35(b) and 43 respectively.

> (b) The "interested" directors have a personal financial interest adverse to the successful prosecution of the lawsuit, and the so-called "non-interested" directors are beholden to the Adviser; they receive aggregate remuneration of approximately $300,000 a year as directors of the Fund and other funds managed by the Adviser.
>
> (c) All of the directors voted to distribute the false proxy statement so that any suit brought to establish liability for the falsity of the statement would establish their own culpability and liability.
>
> (d) The directors caused the Fund to oppose the action on substantive grounds.

In addition, the complaint alleges that the directors are under the control of the Adviser and that application of a demand requirement would be inconsistent with the federal policy underlying Section 20 of the Investment Company Act. In deposition testimony, the directors testified that they would not institute this action. In short, as alleged in the complaint, making a demand on the Fund or its directors to institute or prosecute this action would be futile.

With respect to both the Section 20(a) claim and the Section 36(b) claim, the complaint seeks damages only.

Defendants moved to dismiss plaintiff's claim of proxy fraud, and to strike plaintiff's demand for a jury trial. The District Court granted defendants' motion to dismiss the proxy fraud claim on the ground that plaintiff had failed to justify the absence of a demand upon the Fund directors to institute suit to recover for that claim. With respect to the Section 36(b) claim, the District Court struck plaintiff's jury demand on the ground that "the

action is essentially in equity and therefore not covered by the Seventh Amendment."

Plaintiff sought mandamus, with respect to the striking of the jury demand, in the Court of Appeals. The Court of Appeals denied the petition for mandamus without any opinion other than to cite *First National Bank of Waukesha v. Warren*, 796 F.2d 999 (7th Cir. 1986). In *Waukesha* the Seventh Circuit held that mandamus was not available to review the striking of a jury demand unless the denial of the jury right was irreparable upon appeal from a final judgment. This Court denied certiorari over Justice White's dissent. *Kamen v. Nordberg*, 485 U.S. 939 (1988).

Thereafter, the District Court, adopting the recommendation of a magistrate, dismissed the Section 36(b) claim on the ground that the plaintiff is an inadequate shareholder representative. Upon appeal the Court of Appeals reinstated the Section 36(b) claim, but affirmed the dismissal of the proxy fraud claim and the striking of the jury demand. With respect to the Section 20 dismissal, the Court of Appeals held that demand on directors must be made even if it be futile. With respect to the striking of the jury, the Court recognized that this Court's recent decision in *Teamsters Local No. 391 v. Terry*, 110 S. Ct. 1339 (1990), "appears to call into question the foundation" for prior opinions striking jury demands, but nevertheless adopted the holdings and rationale of one of those opinions (*In re Evangelist*, 760 F.2d 27 (1st Cir. 1985)).

REASONS FOR GRANTING THE WRIT

A. Demand Upon Directors

1. The Court of Appeals decision conflicts with applicable decisions of this Court.

The Court of Appeals based its holding with respect to demand on Rule 23.1 of the Federal Rules of Civil Procedure. The Rule provides, in pertinent part, that the complaint must allege the efforts made by the plaintiff to obtain the action she desires from the directors, "and the reasons for the plaintiff's failure to obtain the action or for not making the effort." As the Court below conceded, the rationale of the demand requirement "implies a futility exception," "[a]t least in principle." 14a. The concession is advisedly made. In modern times, the futility exception has rarely if ever been authoritatively questioned.[2] Yet the Court below decided that "The time has come to do away with it." 14a.

At least as early as *Hawes v. Oakland*, 104 U.S. 450 (1881), this Court held that a shareholder bringing a derivative action must make a demand upon the directors to institute and conduct litigation unless "it was not reasonable to require it." 104 U.S. at 461.

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[2] "The demand requirement will be excused and the shareholder plaintiff will be permitted to proceed with litigation on behalf of the corporation in cases where the role of the directors in the challenged conduct (or the alleged domination and control of the directors by the alleged wrongdoers) is such that demand would be 'futile.' " Block, Radin and Rosenzweig, *The Business Judgment Rule in Shareholder Litigation*, 45 Bus. Law. 469, 473 (1990); and authorities cited therein.

The futility exception was again recognized in *Doctor v. Harrington*, 196 U.S. 579 (1905), which the Court of Appeals acknowledges as a plausible interpretation of that decision. However, said the Court below, *Doctor v. Harrington* is no longer good law because, in its view, *Doctor* was overruled in all but name by *Smith v. Sperling*, 354 U.S. 91 (1957). 18a. This statement is indeed strange. This Court in *Sperling* approvingly cited *Doctor v. Harrington* no less than three times. And, on the very issue involved here, this Court noted that the District Court had found:

> " . . .
>
> (4) that if demand had been made on Warner Bros. to institute suit, the management would not have been disqualified 'from faithfully doing their duty' as officers and directors but that 'such a demand would have been futile.'[2]

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2. The bill therefore meets the requirements of Rule 23 (b) of the Rules of Civil Procedure, 28 U.S.C.A. that the stockholder show with particularity what efforts he made to get those who control the corporation to take action, 'and the reasons for his failure to obtain such action or the reasons for not making such effort.' And see Hawes v. City of Oakland, 104 U.S. 450, 26 L.Ed. 827; Delaware & Hudson Co. v. Albany & S. R. Co., 213 U.S. 435, 29 S. Ct. 540, 53 L.Ed. 862."

354 U.S. at 94 (footnote by the Court).

The Court below sought to sustain its position that *Sperling* effectively overruled *Doctor* by quoting language in the opinion bemoaning the delay attributable to the

demand issue. It is clear, however, that this Court was criticizing the expenditure of time by the lower courts in inquiring into what were essentially issues on the merits rather than accepting the complaint's allegations with respect to the preliminary issue of demand.

Delaware & Hudson Co. v. Albany & Susquehanna R.R., 213 U.S. 435 (1909), specifically recognized the futility exception. The Court of Appeals held that *Susquehanna* "is of no consequence" (19a) because it relied upon Rule 94 which has been amended many times in the course of its transformation to Rule 23.1. Assuming that the *Susquehanna* holding could be read more broadly, the Court of Appeals nevertheless felt it could be disregarded as "linked to its time." That is because the development of committees of independent directors washes away the assumptions upon which this Court has endorsed the futility exception to the demand requirement.

The difficulty with this approach of the Court of Appeals is that, contrary to its assumption that action by independent directors did not exist until the 1970's, committees of independent directors or disinterested officers representing the corporation have been formed to deal with interested director transactions since early in this century; *see, e.g.*, Note, *Legal Safeguards About Transactions Between a Director and the Corporation*, 83 U. Pa. L. Rev. 56, 59 (1934); Note, *Restrictions on Power of Directors To Contract*, 29 Colum. L. Rev. 338 (1929). Moreover, even were there validity to the Court of Appeals' assertion that the proliferation of committees of independent directors has washed away the rationale for prior Supreme Court decisions, that Court overstepped its bounds in overruling

the decisions of this Court. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917, 1921 (1989):

> If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, the Court of Appeals should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions.

Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984), again illustrates the vitality of the futility exception. The Court below seeks to distinguish *Fox* on the ground that the futility there arose from the fact that the corporation was not empowered to bring the action; only the shareholder (or the Securities and Exchange Commission) could do so. But here, the Court does not question that, in fact, a demand would be futile; the directors will not initiate the lawsuit. Many of the arguments advanced in favor of requiring a useless act are the same arguments that were advanced in *Fox*. Thus the Court of Appeals suggests that a demand may lead to a renegotiating of the advisory contract, a changing of the level of services or even finding a new adviser. 10a. Acts short of litigation, says the Court, could have net benefits exceeding those of litigation. Similarly, in *Fox* the petitioner argued that, even if a demand be futile, it enables corporate management to pursue alternative remedies such as negotiating with the Adviser to obtain a return of fees and/or to terminate the advisory contract. Pet. Br. in *Fox*, pp. 17-18. This Court refused to accept the invitation to require plaintiff to perform a futile act.

Finally, it should be noted that the Court of Appeals declined to consider the impact of Maryland law, because

its applicability was not suggested until the filing of the reply brief.[3] Conversely, however, the defendants never

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[3] In the present case, the Fund was a Maryland corporation when the action was commenced. The leading Maryland case is *Parish v. Maryland & Virginia Milk Producers Association*, 250 Md. 24, 242 A.2d 512 (1967), *cert. denied*, 404 U.S. 940 (1971). That case held that where the directors were involved in the wrongdoing, as they were here by sending out the false proxy statement, demand upon them to bring the action is properly excused. *Parish* also held that demand was excused because the directors affirmed their support of management's action after the commencement of the law suit. 242 A.2d at 546-47. To similar effect in applying Maryland law is *Rosengarten v. Buckley*, 565 F. Supp. 193, 197-98 (D. Md. 1982), which holds that under Maryland law, fraud, such as the proxy fraud involved here, vitiates the demand requirement. *See also Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984), citing *Eisler v. Eastern States Corp.*, 182 Md. 329, 333 (1943), and *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978). In the last cited case, the Court, applying Maryland law, concluded, 77 F.R.D. at 740:

> "Accordingly, given plaintiff's allegations that all of the trustees either actively participated in the wrongful transactions or, at the least, approved or ratified such transactions with knowledge or notice of their illegality, the court concludes that demand upon the trustees to bring this action should be excused."
>
> . . . the conduct of the unaffiliated trustees in this action, which conclusively demonstrates their antagonism to it. ANRET's answer did not take a neutral position. Nor did ANRET merely oppose this action on the basis of lack of demand on the trustees or its shareholders. Rather, ANRET has vigorously opposed this action on the merits. In this regard, there is also authority that a demand upon directors or trustees is unnecessary where the derivative entity contests the action on the merits. *See, e.g.*,

(Continued on following page)

suggested, either in the District Court or in the Court of Appeals, that the futility exception be abolished. That was an undertaking solely by the Court of Appeals without warning to any of the parties.

The effect of the Court of Appeals decision in the instant case is to preclude shareholder enforcement of proxy violations under the Investment Company Act or the Securities Acts generally. But more broadly, as the Court below recognized (12a), requiring a futile "demand to the board puts the plaintiff out of court" in all but the most extraordinary cases. This Court has recognized the importance of shareholder actions in enforcing the securities laws and in policing corrupt management; *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964) ("Private enforcement of the proxy rules provides a necessary supplement

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(Continued from previous page)

Meltzer v. Atlantic Research Corp., 330 F.2d 946, 948 (4th Cir.), *cert. denied sub nom., Scurlock v. Meltzer*, 379 U.S. 841, 85 S. Ct. 78, 13 L.Ed.2d 47 (1964).

Pursuant to *Burks v. Lasker*, 441 U.S. 471, 477-80 (1979), procedural questions such as demand are decided by reference to state law unless inconsistent with federal law in the sense that application of the state rule destroys the federal right. (The complaint herein alleges that application of a demand requirement would be inconsistent with the federal policy underlying Section 20 of the Investment Company Act; 93a.) The Court of Appeals opinion turns this guiding principle on its head by utilizing a concocted federal demand theory to prevent enforcement of a federal right, which enforcement would be countenanced by Maryland demand law.

to Commission action.");[4] *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966) (" . . . derivative suits have played a rather important role in protecting shareholders of corporations from the designing schemes and wiles of insiders who are willing to betray their company's interests in order to enrich themselves."). The Court of Appeals decision is in conflict with these holdings.

2. The Court of Appeals decision conflicts with decisions of other Courts of Appeals as well as prior decisions of its own.

The vast majority of Circuits – indeed, every Circuit Court of Appeals which has ruled upon the issue – has held that demand is excused where it would be futile. Illustrative of the cases are the following: *Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59 (D.C. Cir. 1988); *Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22 (1st Cir. 1978); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946 (4th Cir.), *cert. denied, sub nom., Scurlock v. Meltzer*, 379 U.S. 841 (1964); *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); *Allright Missouri, Inc. v. Billeter*, 829 F.2d 631 (8th Cir. 1987); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980). In addition, District Courts in the Sixth,

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[4] The General Accounting Office recently found that the SEC lacks the resources to adequately regulate investment advisers, who currently manage about $4.6 trillion in assets. GAO, Investment Advisers (June 1990), GGD-90-83.

Tenth and Eleventh Circuits have similarly held: *Granada Investments, Inc. v. DWG Corp.*, 717 F. Supp. 533 (N.D. Ohio 1989); *Mullen v. Sweetwater Development Corp.*, 619 F. Supp. 809 (D.C. Colo. 1985); *First American Bank and Trust v. Frogel*, 726 F. Supp. 1292 (S.D. Fla. 1989). And prior decisions of the Court of Appeals for the Seventh Circuit also held that demand is excused where futile: *Thornton v. Evans*, 692 F.2d 1064 (7th Cir. 1982); *Nussbacher v. Continental Illinois National Bank*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976). The decision below is a conscious and defiant break with the uniformity required – and, until now, adhered to – by this Court's carefully enunciated jurisprudence.

B. The Right To Trial By Jury

The Court of Appeals decision conflicts with applicable decisions of this Court

This Court has long recognized that the right to trial by jury is a basic and fundamental element of constitutional philosophy. *Simler v. Conner*, 372 U.S. 221, 222 (1963); *Bailey v. Central Vermont R. Co.*, 319 U.S. 350, 354 (1943). Because the Court below upheld the dismissal of the proxy fraud claim, it did not consider plaintiff's right to a jury trial thereunder.

Plaintiff's Section 20 claim for damages resulting from shareholder reliance on fraudulent misrepresentations in the Fund's proxy statement is an action to recover money damages. The materiality of fraudulent statements in proxy solicitations is a jury issue. *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 337, 355 (1979) (dissenting opinion). Plaintiff is clearly entitled to a jury trial on a

claim of proxy fraud; *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 31 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972).

Plaintiff is also entitled to a jury trial on her claim under Section 36(b). The Court below recognized that this Court's decision in *Teamsters Local No. 391 v. Terry*, 110 S. Ct. 1339 (1990) "appears to call in question the foundation" for earlier Courts of Appeals decisions[5] striking jury demands in actions brought under Section 36(b). Nevertheless, it accepted the guidance of those decisions rather than of this Court's teaching.

In *Terry* employees sued their Union for breach of the duty of fair representation, seeking as relief the back pay which they had lost. This Court held that the action was analogous to an equitable suit by a trust beneficiary against a trustee for breach of fiduciary duty. Nevertheless, said the Court, quoting *Ross v. Bernhard*, 396 U.S. 531, 538 (1970), "The Seventh Amendment question depends on the nature of the *issue* to be tried rather than the character of the overall action." (110 S. Ct. at 1347; emphasis added by the Court in *Terry*). Quoting from *Curtis v. Loether*, 415 U.S. 189, 196 (1974), the Court noted that "an action for money damages was 'the traditional

[5] The First Circuit in *In re Evangelist*, 760 F.2d 27 (1st Cir. 1985), and the Second Circuit in *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404 (2d Cir.), *cert. denied*, 110 S. Ct. 281 (1989); and *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988), held that the actions were characteristic of equitable suits because they sought relief in the nature of restitution. Earlier, the Second Circuit had held that the jury right depends upon the specific relief prayed for; *In re Gartenberg*, 636 F.2d 16, 18 (2d Cir. 1980), *cert. denied*, 451 U.S. 910 (1981).

form of relief offered in the courts of law.' " (110 S. Ct. at 1347). The Court upheld the right to a jury.

From *Terry* two questions appear to occupy primary importance: Whether the case presents legal issues and whether the relief prayed for is money damages. Justice Brennan, concurring, stated that the nature of the relief sought is paramount. Justice Stevens, concurring, emphasized the nature of the substantive right and whether the relief is typical of an action at law. The dissent urged that the action was analogous to a breach of trust suit and therefore equitable and that the relief sought had to be considered with other factors to determine whether it qualified the case as a common law action.

In the present case several factors combine to confer the right to trial by jury. In the first place the statute specifically authorizes an action for damages; no less than four times is the term used in Section 36(b). Section 36(b) authorizes a shareholder of an investment company to bring an action against an investment adviser or any affiliated person of an investment adviser to recover "damages" or to seek "other relief" with respect to payments made to an investment adviser or affiliated person.

Thus, under Section 36(b) a plaintiff shareholder may seek either damages on the one hand or, on the other hand, equitable relief, such as an accounting or injunctive relief requiring the reduction of fees *in futuro*. The availability of alternative types of relief is confirmed by Section 44 of the Act.

Section 44, upon which jurisdiction of this action is based, confers jurisdiction upon federal district courts over "all suits in equity and actions at law brought to

enforce any liability or duty created by" the Act. The Section thus draws the traditional distinction between a suit in equity and an action at law. With specific reference to Section 36(b), Section 44 goes on to provide "[t]he [Securities and Exchange] Commission may intervene as a party in any *action or suit* to enforce any liability or duty created by, or to enjoin any non-compliance with, section 36(b) of this title at any stage of such *action or suit* prior to final judgment therein." (Emphasis and interpolation supplied). Congress thus recognized in Section 44 that a shareholder's claim under Section 36(b) could be either a legal action (if it sought damages to enforce a duty) or an equitable suit (if it sought equitable relief to enjoin non-compliance). In the present case damages are sought.

Moreover, in this action the common law issue of fraud is presented, not simply by the Section 20 allegations, but also by the fact that under Section 36(b)(2) stockholder ratification must be tempered by the misleading proxy statement.

The Court below sought to distinguish *Terry* because it was the Union rather than the employer which was being sued for back pay. This made the case look more like one for damages than restitution. But the present case is not one for restitution either. Excessive advisory fees are not determined solely by what the Fund pays. Rather, the Court must look at all the facts in connection with the determination and receipt of advisory compensation, including so-called "fall-out" financial benefits received by the adviser; *Gartenberg v. Merrill Lynch Asset*

Management Co., 694 F.2d 923, 930, 932 (2d Cir. 1982), *cert. denied*, 461 U.S. 906 (1983).[6]

Moreover, here, as in *Terry*, the complaint seeks recovery from the Adviser of amounts retained by others. Paragraph 8 of the complaint (88a) attacks amounts paid to affiliates of the Adviser. Under Section 36(b), the Adviser can be held liable for amounts received by affiliates. In short, this action fits well within the constitutional mold of an action at law for damages entitling the parties to a jury trial.

This Court in *Terry* repeated one of the cardinal principles of American constitutional law:

> Maintenance of the jury as a fact-finding body is of such importance and occupies so firm a place in our history and jurisprudence that any seeming curtailment of the right to a jury trial should be scrutinized with the utmost care.

110 S. Ct. at 1344-45.

[6] The limitation in the statute of the amount of damages recoverable does not analogize the case to restitution but rather demonstrates the difference. Without such limitation, the Fund shareholders might well be entitled to a greater recovery as defined by the damages authorized by the statute.

CONCLUSION

The petition for a writ of certiorari should be granted.

Dated: New York, New York
September 20, 1990

Respectfully submitted,

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APPENDIX

IN THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 89-2967

JILL S. KAMEN,

Plaintiff-Appellant,

v.

KEMPER FINANCIAL SERVICES, INC.,
and CASH EQUIVALENT FUND,

Defendants-Appellees.

Appeal from the United States District Court
for the Northern District of Illinois, Eastern Division.
No. 85 C 4587 – **Marvin E. Aspen,** *Judge.*

ARGUED MAY 11, 1990 – DECIDED JULY 18, 1990

BEFORE CUMMINGS, EASTERBROOK, and RIPPLE, *Circuit Judges.*

EASTERBROOK, *Circuit Judge.* Cash Equivalent Fund is a money market mutual fund with a sweeps feature. Brokers offer the Fund to their customers as an adjunct to their principal accounts. When an account has a cash balance, a computer "sweeps" the money into the Fund, where it earns interest until the customer reinvests in stocks or other financial instruments; the Fund redeems shares automatically to supply the cash for these transactions. The Fund and its investment adviser, Kemper

Financial Services, Inc., say that the extra costs of implementing a sweeps feature and the additional transactions it generates, plus the check-writing and wire transfer features of the Fund, justify a fee exceeding the norm for money market funds. Kemper receives an annual administration fee of 0.38% of the Fund's assets. It also receives an investment management fee starting at 0.22% of the first $500 million of the Fund's assets and dropping in increments to 0.15% of the assets exceeding $3 billion. As a result of these fees, the Fund pays interest at a rate approximately 0.2% per annum lower than money market funds that operate passively, including one that Kemper itself manages, the Kemper Money Market Fund.

Despite the difference in fees and payouts, the Fund has grown steadily and now manages more than $5 billion of assets. One might think this judgment of investors dispositive: offered extra services at lower interest, the Fund's investors chose the extra services; others have sent their money elsewhere to get a higher return. Whether the extra services are "worth" the price is the sort of judgment people make every day when deciding whether to buy a stripped down computer or pay extra for one with bells and whistles; our government does not try to determine whether extra features are worth a higher price.

Things are not so simple when the services are rendered by an investment adviser rather than a manufacturer or retailer of computers. Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. §80a-35(b), provides that the adviser of a registered investment company "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services".

Fiduciary duties require honest dealing. Managers of all corporations owe fiduciary duties to their firms. These duties have never been thought to justify judicial review of levels of compensation paid, short of extreme cases amounting to waste. Nonetheless, §36(b) has been understood in light of its legislative history to put investment advisers on leases shorter than those of corporate managers generally, and to require the federal courts to decide whether the fees charged by investment advisers are "excessive". *Daily Income Fund, Inc. v. Fox,* 464 U.S. 523, 534-41 (1984).

Jill S. Kamen, who owns shares of the Fund, filed this suit under §36(b), contending that Kemper's fees are excessive and should be reduced, with excess fees for prior years returned to the Fund. Kamen added a claim that in soliciting the investors' approval of the fee structure in 1984, the Fund had misleadingly compared the fees it pays to Kemper with the fees the Kemper Money Market Fund pays. Cash Equivalent Fund pays approximately 0.2% of its assets per annum more than the Money Market Fund does; Kamen believes that the proxy statement implied that the Fund's fees are equivalent to or lower than those paid to the Money Market Fund. Section 20(a), 15 U.S.C. §80a-20(a), forbids using the mails to send a proxy statement that violates rules established by the Securities and Exchange Commission. The SEC has by rule under the Investment Company Act adopted its rules under the Securities Exchange Act of 1934, which forbid materially misleading statements. See 17 C.F.R. §§270.20a-1(a), 240.14a-9(a).

Judge Nordberg first held that §20(a) creates a private right of action, 659 F. Supp. 1153 (N.D. Ill. 1987), and

then dismissed the portion of the complaint based on the proxy solicitation in 1984, holding that Kamen needed but had neglected to make a demand on the Fund's board of directors. See Fed. R. Civ. P. 23.1. He also struck Kamen's demand for a jury trial on the demand for restitution of excessive fees. We denied Kamen's petition for mandamus in an unpublished order because any error could be reviewed on appeal from a final decision, and the Supreme Court denied certiorari over Justice White's dissent, which observed that other courts of appeals disagree with *First National Bank of Waukesha v. Warren*, 796 F.2d 999 (7th Cir. 1986), on which the decision rested. *Kamen v. Nordberg*, 485 U.S. 939 (1988).

Although *Fox* holds that an investor need not made [sic] a demand on the directors when proceeding under §36(b), that claim did not last much longer. Judge Nordberg asked a magistrate to analyze Kemper's argument that Kamen is not an adequate representative of the other investors in the Fund. The magistrate recommended that the court grant summary judgment for the defendants on the §36(b) claim because Kamen is not an adequate representative of the class under Fed. R. Civ. P. 23. Magistrate Balog wrote:

> [N]o other shareholder has joined in this suit, instituted a claim, or inquired into plaintiff's action; the other shareholders have approved the fees charged by Kemper; after notice of plaintiff's allegations, the shareholders approved an increase in fees. Based on these facts, it can only be said that plaintiff's interests are antagonistic to those of the other shareholders. In such a case, plaintiff cannot adequately protect those interests. . . . It is apparent from the record as it stands that plaintiff's concerns are not those of a class, but are a private matter. As such, plaintiff cannot maintain this suit as a class action.

Judge Aspen, to whom the case was transferred for decision, adopted the magistrate's report and granted the "motion for summary judgment on the issue of plaintiff's adequacy as a class representative. This cause may proceed, if plaintiff so chooses, as a non-class action." After the parties pointed out that the suit was not filed as a class action, and that adequacy of representation is material (if at all) only under Rule 23.1, which governs derivative actions, the court entered judgment for the defendants, stating that because "plaintiff was adjudicated as a non-adequate representative plaintiff cannot proceed individually".

Kamen's appeal presents three questions: whether the §20 claim should have been dismissed for failure to make a demand on the directors; whether the §36(b) claim should have been dismissed because she stands alone among the Fund's shareholders; and whether, if the §36(b) claim should be reinstated, she would be entitled to a jury trial. Defendants maintain that only questions about the adequacy of representation are properly before us, because only that question was resolved in the final decision, and the notice of appeal identified only that decision as the subject of appeal. Defendants misunderstand the rules governing issues that may be litigated on appeal. An appeal from the final judgment brings up for review all decisions that shaped the contours of that judgment. E.g., *Chaka v. Lane*, 894 F.2d 923 (7th Cir. 1990); *Kaszuk v. Bakery & Confectionery Union*, 791 F.2d 548 (7th

Cir. 1986). It is unnecessary to identify earlier interlocutory orders in the notice of appeal. These orders may not themselves be appealed; they are not "final" and so are outside the scope of 28 U.S.C. §1291. Kamen's notice of appeal specified the final decision, and we have jurisdiction to review all of the legal questions preserved in the district court and in this court affecting the validity of that decision.

I

Kamen's complaint as finally amended alleges that she did not make a demand on the board of directors because the seven independent directors (of the ten-member board) "receive aggregate remuneration of approximately $300,000 a year for serving as directors of the Fund and all of the other funds in the Kemper group" and therefore "are dependent upon and subservient to" Kemper. It alleges in addition that demand would be futile because the Fund solicited the proxies, so a demand would request that the directors sue themselves, and that because the Fund has asked for the dismissal of the suit on the merits the directors obviously are not interested in pursuing the claims. Judge Nordberg thought these allegations insufficient to excuse a demand under Rule 23.1, as do we.

It is far from clear that Rule 23.1 applies to a suit under §20 of the Investment Advisers Act. The Rule applies to a "derivative action brought . . . to enforce a right of a corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted

by it". Violations of §20 do not yield rights "of the corporation" in the customary sense. Kamen does not sue in the right of the Fund; she sues the Fund for injury done her by the Fund. The theory of a suit under the proxy rules is that the corporation violated a right of the investor to truthful information. If the investor recovers against the corporation, it may in turn seek to recover from its directors, but the principal wrong is by the corporation against the investors. Kamen conceded in the district court, and again at oral argument in this court, that Rule 23.1 applies to her claim under §20. Perhaps she did this because she seeks as relief a payment to the Fund, and not a remedy for the investors personally. Whatever the reason for the concession, the question is not presented and we express no opinion on it. Similarly, we express no view on the question whether §20 creates a private right of action, and if so what the appropriate remedy may be. The district court held that the statute creates a right of action, 659 F. Supp. at 1156-60; our conclusion concerning the demand requirement makes it unnecessary to decide whether to imply such a right. See *Burks v. Lasker*, 441 U.S. 471, 475-76 & n.5 (1979).

The district court asked whether Kamen had satisfied the demand requirement of Rule 23.1, and the briefs on appeal debate the issue in these terms. Yet as we held in *Starrels v. First National Bank of Chicago*, 870 F.2d 1168, 1170 (7th Cir. 1989), Rule 23.1 governs pleading but does not create a demand requirement. Rule 23.1 requires the complaint to say with particularity what has been done about demand and why. Plaintiff may comply by saying that she made a demand or that a rule of law excuses demand.

What is the source of the rules requiring or excusing demand? When the claim for relief is based on state law, we held in *Starrels*, the law of the state in which the defendant is incorporated governs. See also *Burks*, 441 U.S. at 477-78. When the claim for relief is based on federal substantive law, then federal law also governs the requirement of demand. See *Burks*, 441 U.S. at 475-77. But cf. *Fox*, 464 U.S. at 542-47 (Stevens, J., concurring) (arguing that in cases under federal law there is no demand requirement unless the statute creates one). Federal common law contains a demand rule. *Hawes v. Oakland*, 104 U.S. 450 (1881).

Even when federal common law supplies the rule of decision, it may obtain that rule not from first principles but from state law. *United States v. Kimbell Foods Corp.*, 440 U.S. 715 (1979). This is especially appropriate under Rule 23.1, because the demand requirement is an aspect of the division of authority between corporate managers and investors, a division usually governed by state law. *Burks* holds that federal law with respect to directors' power to dismiss derivative suits should be derived from state law, unless the state law is hostile to federal interests. Perhaps the demand requirement, too, should be absorbed from state law. Few courts have considered this possibility. Cases both before and after *Burks* hold or assume that the demand requirement is a creature of federal law. See, in addition to *Hawes* and the cases cited in *Starrels*, 870 F.2d at 1170 n.4, our own opinions in *Nussbacher v. Continental Illinois National Bank*, 518 F.2d 873 (7th Cir. 1975), and *Thornton v. Evans*, 692 F.2d 1064, 1079-81 (7th Cir. 1982). Not until Kamen filed her reply brief in this court had anyone doubted that federal law defines the demand

requirement in this case. Kamen's reply brief suggested that we import the rules from Maryland law. (The Fund is a Maryland corporation.) The suggestion comes too late, *Wilson v. O'Leary*, 895 F.2d 378, 384 (7th Cir. 1990); we shall follow the tradition of *Hawes* and use federal common law.

The scope of the demand requirement depends on why demand *ever* is required. The demand rule could reflect a hope that the dispute will go away without litigation, that the board of directors will "do something" (or persuade the putative plaintiff that suit is pointless). Demand then initiates a form of alternative dispute resolution, much like mediation. Steps to control the volume of litigation are welcome, yet the demand rule creates more litigation than it prevents. It is difficult to identify cases in which the board's response to a demand satisfied the shareholder and thus prevented litigation; even if the board acts the shareholder may believe the board did too little. It is easy to point to hundreds of cases, including this one, in which the demand requirement was itself the centerpiece of the litigation. An approach uncertain in scope and discretionary in operation – that is, any rule except one invariably requiring or excusing demand – promotes litigation. When the stakes are high (as they frequently are in cases of this character), even a small disagreement between the parties about the application of a legal rule makes it difficult to resolve disagreements amicably.

A stronger rationale for the demand requirement is the one *Hawes* gives – that it allows directors to make a business decision about a business question: whether to

invest the time and resources of the corporation in litigation. 104 U.S. at 457, 461-62. See also *Fox*, 464 U.S. at 532-33; Deborah A. DeMott, *Demand in Derivative Actions: Problems of Interpretation and Function*, 19 U.C. Davis L. Rev. 461, 484-88 (1986); Daniel R. Fischel, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171-72 (1976). Firms must make operational decisions; if these misfire, they must decide what to do next. Each decision must be made with the interests of the corporation at heart. Whether to buy a particular combination of services at a particular price is a business decision. So too the decision to file a lawsuit about the price or pursue a different course, such as renegotiating the contract, changing the level of services, even finding a new adviser. Even doing nothing is justified when the resources of top managers required to act exceed the injury to the firm; when "something must be done", acts short of litigation could have net benefits exceeding those of litigation. If the directors run the show, then they must control litigation (versus other remedies) to the same extent as they make the initial business decision.

Choosing between litigation and some other response may be difficult, depending on information unavailable to courts and a sense of the situation in which business executives are trained. Managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism "selects out" judges who try to make business decisions. In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors. If principles such as the "business judgment rule" preserve room for managers to err in making an operational decision, so too they preserve room to err in deciding what remedies to pursue. *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-64 (1917).

Consider now why plaintiffs may resist making demand. (a) Delay in starting the litigation while the board ponders may injure the firm, perhaps because the statute of limitations is about to expire, perhaps because a questionable transaction is about to occur and it will be hard to unscramble the eggs if it happens before the court can act. (b) Demand may be futile, in the sense that the members of the board are interested in the transaction and unwilling to sue themselves, or because they are so set against litigation that their minds are closed. (c) Demand may be pointless, in the sense that a substantive rule prevents the corporation from controlling the litigation. *Fox* held that only an investor or the SEC may initiate litigation under §36(b), and it followed from the firm's inability to file its own case or prevent the investor from litigating that demand was unnecessary. Other statutes likewise may eliminate the point of making demand. (d) Demand may sometimes be imprudent from the plaintiff's perspective. Counsel who fear that the board *will* sue may hesitate before making a demand, because if the firm sues counsel will not reap the legal fees of victory. Or counsel may think that the board will pursue a strategy in litigation that his client disapproves, or settle for too little.

We will return to these four. Perhaps the most serious difficulty with demand from the perspective of plaintiffs is the link between the making of demand and the standard courts apply to the directors' decision not to sue. In

Delaware, the Mother Court of corporate law, any shareholder who makes a demand is deemed to concede that demand was required. *Spiegel v. Buntrock*, 571 A.2d 767, 775 (Del. 1990); *Stotland v. GAF Corp.*, 469 A.2d 421 (Del. 1983). If demand is required, then the disinterested members of the board are deemed to possess the ability to refuse to sue or control the litigation, provided their decisions are sufficiently reasoned to come within the capacious bounds of the business judgment doctrine. *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); see also, e.g., *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984). Except in extraordinary cases, then, tendering a demand to the board puts the plaintiff out of court under Delaware law. No wonder plaintiffs stoutly resist making demands.

Federal courts have never embraced Delaware's link between the making of a demand and special deference to the board's decision not to sue. See *Bach v. National Western Life Insurance Co.*, 810 F.2d 509, 513 (5th Cir. 1987); *Joy v. North*, 692 F.2d 880, 888 n.7 (2d Cir. 1982) (Winter, J.). See also *Alford v. Shaw*, 358 S.E.2d 323, 327 (N.C. 1987) (rejecting a tie between demand and the standard of review). We think it would be unwise to do so. When the standard of review depends on the existence of a demand, plaintiffs have extraordinarily strong reasons not to make a demand, and corporations extraordinarily strong reasons to insist on one. Demand then becomes a threshold issue in every derivative suit, one that must be resolved in advance of discovery and on the basis of a good deal of speculation about what the board might do. As in *Spiegel*, the plaintiff will assert that the board is unreasonable. Why ask persons with closed minds? The

board will proclaim that Solomonic wisdom would be applied if only plaintiff would ask, while simultaneously asserting that the suit has no conceivable merit. It is not a pretty picture, but it is an extended and expensive one, made more so by some peculiarities in the way Delaware phrases its standards. See *Starrels*, 870 F.2d at 1174-76 (concurring opinion). As the American Law Institute has observed, "the need for demand and the standard of judicial review are logically very distinct." *Principles of Corporate Governance: Analysis and Recommendations* §7.03 comment *a* at 65 (Tent. Draft No. 8, 1988). We conclude that when the demand requirement comes from federal common law, the making of a demand does not affect the standard with which the court will assess the board's decision not to sue.

Four reasons remain why demand may be inappropriate: (a) exigencies of time; (b) futility; (c) irrelevance given a substantive rule; (d) the risk that demand will lead to suit and so deprive counsel of fees that might have been obtained were it necessary to file a derivative suit. We may at once discard (d) as a legal excuse. Cases in category (c) obviously never require demand. Cases in category (a) justify filing the complaint before receiving the board's answer to the demand but do not justify failure to make a demand. When time is tight, the investor should make demand at the same time he files the complaint. See *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435, 447 (1909). Category (b), futility, is the usual sticking point. The plaintiff asserts that the board is interested or intransigent; the board asserts that it is reasonable and wise. Courts predictably

have great difficulty deciding who is right when, as is usual, it must decide such questions on the pleadings.

At least in principle the rationale of the demand requirement implies a futility exception. If courts would not respect the directors' decision not to file suit, then demand would be an empty formality. When all directors have a financial stake in the transaction, their decision not to sue themselves would carry little weight with a court. Or perhaps all of the directors are so ensnarled in the transaction that even when only the duty of care is at stake, their judgment could not be respected. Again demand seems an empty gesture. Courts dispense with futile gestures.

"In principle" is an important qualifier. In practice the futility exception to the demand rule has produced gobs of litigation. It is this exception that has sapped the potential role of the demand requirement as an alternative dispute resolution mechanism. Hundreds of cases opine on whether demand is or is not futile. Difficulties in sorting cases into demand-required and demand-excused bins are not worth incurring, once we sever the link between demand and the standard of review (as we have done). The American Law Institute recommends that courts abolish the "futility" exception to the demand rule, turning demand into an exhaustion requirement with much the same scope and function as the exhaustion requirement in the law of collateral review of criminal convictions. *Principles of Corporate Governance* §§7.03, 7.08, and commentary at 64-71 (Tent. Draft No. 8, 1988). "The futility exception . . . [is] ambiguous in scope and has proven a prodigious generator of litigation." *Id.* at 64. The time has come to do away with it. If demand is useful,

then let the investor make one; if indeed futile, the board's response will establish that soon enough. In either case, the litigation may proceed free of arguments about whether a demand should have been made in the first place. The virtue of simplification may be seen by considering three of the common battles about the meaning of "futility".

1. The plaintiff may say that some or all of the members of the board approved or are interested in the transaction and that demand is futile because they will not sue themselves or contest their own acts. Although directors are unlikely to sue themselves, they may well take some action to palliate the consequences of poorly conceived acts, including their own. Directors want the venture to succeed, and if shown how they can improve its prospects, are likely to act. One mistake at the time of the initial decision does not imply that the member of the board opposes remedial action. Even when the "action" involves suit against some of their number, this does not disable the board. The ALI properly observes, *id.* at 70-71, that the board may appoint a minority of disinterested members to evaluate the demand and act for the corporation. In the extreme case in which all members are implicated, the board may expand its size and authorize the new members to act for the firm. Of course it may choose to do none of these things, but if so it will just decline the demand. Making a demand is cheap, *especially* so when the board is disabled from acting. Why prefer extended, costly litigation to the cheap and quick expedient of a demand?

2. The board may be determined not to sue. Perhaps by the time the judge comes to consider whether plaintiff

should have made a demand, the defendant will have moved to dismiss the case on the merits. Any demand in such a case would be doomed to failure, and even at an earlier stage it may be transparent that the directors want nothing to do with litigation. This application of the "futility" exception has both a practical and a conceptual difficulty. The practical one is that it is difficult to tell in advance just what position the firm would take if asked; disputes about the demand requirement usually are resolved before the defendants plead to the merits. It is easy for the plaintiffs to *say* (and for the defendants to deny) that the board has a closed mind; it is much harder to tell who is right.

The conceptual difficulty is that even an adamant unwillingness to sue may reflect the merits. Boards ought not pursue silly or frivolous claims. So certain knowledge that the board is unwilling to authorize litigation may reflect only confidence that the case is feeble or injurious to the firm and other investors. Why should the plaintiffs be authorized to sue, and without so much as a request to the board, just because the complaint is all heat and no light? Once more the ALI hit the nail on the head when observing that a formulation of the futility rule that inquires whether a demand would prompt the board to correct a wrong "assumes that there is a wrong to be corrected. The director's antagonism to an action may well be justified and flow from a sound judgment that the action is either not meritorious or would otherwise subject the corporation to serious injury." *Id.* at 69. A decision not to file a weak lawsuit would be protected by the business judgment rule, so it makes perfect sense to ask for the board's perspective.

3. A plaintiff may insist that even the independent directors are toadies, so that their judgment could not be respected. Perhaps they are friends of the putative defendants; perhaps they draw hefty directors' fees and fear loss of their offices if they authorize suit; perhaps they believe that the courts have no business supervising corporate affairs and would not authorize litigation no matter how meritorious (and no matter how little their regard for holding onto their offices). If demand is futile in fact for any of these reasons, then the board will say no with dispatch and the case may proceed. As we have broken the link between the demand and the standard of review, the plaintiff may employ this arsenal of arguments to argue that the decision not to sue ought not be respected; the board will stand on the business judgment rule. The court will resolve the question on the merits rather than trying to treat it as a procedural hurdle. Framing questions about the independence of the directors as exceptions to the demand requirement diverts attention from the real issues.

Kamen's complaint pursues all three of these arguments for futility and has all the weaknesses we have identified. Courts frequently say that considerations of this sort do not demonstrate futility. The district court's able opinion collects many of the holdings, 659 F. Supp. at 1161-63. We are in accord, as *Starrels* demonstrates. Yet other cases, such as our opinions in *Nussbacher* and *Thornton*, accept the board's actual or anticipated unwillingness to sue as futility adequate to excuse demand, greatly complicating the resolution of litigation. The line between "potential futility" and "real futility" is increasingly refined.

Recent cases in several circuits display impatience with the futility exception and have been creative in denying that a demand would be futile even when it is pellucid that the board is not about to authorize a suit. E.g., *Lewis v. Graves*, 701 F.2d 245 (2d Cir. 1983); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir. 1973). Although none of these opinions dispenses with the exception altogether, the day is at hand – unless decisions of the Supreme Court bar the way.

Two decisions, *Doctor v. Harrington*, 196 U.S. 579 (1905), and *Susquehanna*, arguably adopt a futility exception to the demand requirement for purposes of pre-*Erie* general federal law. Although both of these cases speak favorably of a futility exception to the demand requirement, neither prevents the evolution of the federal common law.

Doctor raised the question whether the corporation should be aligned as a plaintiff or a defendant for purposes of diversity jurisdiction. The firm is a defendant to the extent the investor complains that it failed to bring suit; it is a plaintiff to the extent that the derivative suit may end in an order compelling the wrongdoers to pay money to the corporation. *Doctor* holds that the firm should be aligned as a defendant when the board is so hostile to the investors that demand would be futile; otherwise it should be aligned as a plaintiff. Many people (including the Supreme Court in *Susquehanna*, 213 U.S. at 449-50) understood this as implying a futility exception to the demand requirement. Although this may have been a plausible inference, *Doctor* is no longer good law. It was overruled in all but name by *Smith v. Sperling*, 354 U.S. 91

(1957), which holds that in a derivative suit the corporation always should be aligned as a defendant for purposes of determining complete diversity. After *Sperling* "futility" is unimportant. When explaining why it would no longer use the board's refusal to sue as the basis of the alignment decision, the Court gave an explanation equally applicable to the futility exception to the demand rule in general: "To stop and try the charge of wrongdoing [in refusing to sue] is to delve into the merits. That does not seem to us the proper course. It is a time-consuming, wasteful exertion of energy on a preliminary issue in the case. The instant case is a good illustration, for it has been over eight years in the courts on the question of jurisdiction." 354 U.S. at 95.

Susquehanna interprets old Equity Rule 94, which codified the holding of *Hawes*. Rule 94 required demand, leaving no (apparent) room for exceptions. *Susquehanna* holds that the rule was not so inflexible. This *holding* is of no consequence; Rule 94 is no longer with us, having been amended many times in the course of the transformation to Rule 23.1. See *Fox*, 464 U.S. at 530-31 n.5. But the discussion of futility, 213 U.S. at 447-52, may be thought to establish a doctrine independent of the defunct equity rule. If this was the Court's meaning, the decision is nonetheless linked to its time. *Susquehanna* assumed that if the members of the board were implicated in the transaction, or held financial interests in the party to be sued, they would be incompetent to act on a demand. Although that is so as a matter of corporate law, the court did not consider the possibility that a committee of independent directors could act on the demand. Not

until the 1970s did courts hold that an independent committee could act on demands – and control litigation in the name of the corporation – even though a majority of the board was interested in the transaction. Development of the independent committee washed away the assumption on which the discussion in *Susquehanna* depends. The Court has never endorsed a "futility" exception to the demand requirement under current assumptions about the ability of committees to act for boards of directors, and given the statement in *Sperling* about the wastefulness of inquiries into futility we are confident it would not do so.

We conclude that precedent does not prevent us from holding that claims of futility should be tested by *making* the demand rather than by arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law, which applies in light of the holding of *Burks*. See also *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Hill v. Wallace*, 259 U.S. 44, 61 (1922); *United Copper*, 244 U.S. at 264. As we have rejected *Zapata*, the making or failure to make a demand will not alter the business judgment standard that ordinarily applies to corporate decisions. Courts now may focus on the question whether the board's actual decision should be given force, rather than on hypothetical inquiries. "Futility" is the only reason Kamen gives for not making a demand on her claim under §20(a). As this is an unsatisfactory reason, we agree with the district court's decision that the claim must be dismissed for failure to make a required demand.

Abolition of the futility exception calls into question our holdings in *Thornton* and *Nussbacher*. *Thornton* was a

suit under ERISA, and the court extensively discussed the policies behind ERISA before deciding that demand would be futile. It may be that *Thornton*, like *Fox*, illustrates our category (c): Demand is not required when under substantive law the board may neither control nor prevent litigation. That question must be left for another day. *Nussbacher*, on the other hand, was founded squarely on the futility exception. The panel held that demand was excused because it was clear from the defendants' motion to dismiss the suit on the merits that demand would have been futile, 518 F.2d at 878-79. *Nussbacher* reasoned that because Rule 23.1 allows the plaintiff to plead reasons why demand is excused, it must follow that the futility of demand is an adequate excuse. In other words, *Nussbacher* treated Rule 23.1 itself as the source of the substantive requirements, a position we repudiated in *Starrels*, applying the rationale of *Burks*. Other decisions regularly hold that the board's defense of the suit on the merits does not justify failure to make demand. E.g., *Grossman v. Johnson*, 674 F.2d 115 (1st Cir. 1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir. 1978). Lest *Nussbacher* be thought to represent an independent assessment of the futility exception with continuing vitality, we now formally overrule that case.*

II

After *Fox* the demand requirement of Rule 23.1 does not apply to a claim under §36(b). The Court held that

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* Because this decision overrules an opinion of this court, it was circulated before release to all judges in active service. See Circuit Rule 40(f). No judge voted to hear the case in banc.

§36(b) creates a right of action that only the investor and the SEC may pursue. Because the mutual fund may not assert a claim against the investment adviser under §36(b), the Court reasoned, Rule 23.1 – which applies only to suits "brought . . . to enforce a right of the corporation . . . , the corporation . . . having failed to enforce a right which may properly be asserted by it" – does not call for a demand on the directors to file suit. What is the point of dunning the directors, if under the statute they may not sue? Our holding with respect to the need for a demand under §20(a) therefore does not affect the claim under §36(b).

A

Judge Aspen dismissed the claim under §36(b) on the basis of Magistrate Balog's conclusion that Kamen is not an adequate representative of other investors in the Fund. Rule 23.1 requires adequacy: "The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association." Yet the very statement of the adequate-representation requirement repeats the theme that Rule 23.1 is limited to suits in which an investor seeks to enforce a *corporate* right. Rule 23.1 imposes hurdles, including both the pleading requirement and the adequate-representation requirement, before a court will strip the directors of their entitlement to manage the affairs of the corporation, including their right to control the pursuit or compromise of its legal claims. *Fox* holds that a claim under §36(b) is *not* a claim "of the corporation", and it follows that Rule

23.1 is inapplicable. Demand requirements and adequate-representation requirements go hand in glove. If the claim under §36(b) is really the investor's *personal* claim, it is unimportant whether Kamen "adequately" represents other investors. Under the statute, she need represent no one.

Kemper relies on footnote 11 of *Fox*, 464 U.S. at 535 n.11, which allows that a suit under §36(b) is "undeniably 'derivative' in the broad sense of that word", because the fiduciary obligation runs to the mutual fund, which will receive any remedy. True enough, but it is of no assistance to defendants. Rule 23.1 does not ask whether a suit is derivative "in the broad sense of that word". It asks whether the suit seeks to enforce a right of the corporation, "the corporation . . . having failed to enforce a right which may properly be asserted by it". *Fox* holds that the claim under §36(b) is not one the corporation may assert. It therefore establishes that Rule 23.1 does not apply, period. The opinion could hardly be clearer. At pages 528, 535 n.11, and again in stating the holding at 542, the Court quotes this language of Rule 23.1 and observes that §36(b) litigation does not fall within the domain of the rule. Lest there be any doubt, the last sentence reads:

> It follows that Rule 23.1 does not apply to an action brought by a shareholder under §36(b) of the Investment Company Act and that the plaintiff in such a case need not first make a demand upon the fund's directors before bringing suit.

464 U.S. at 542. Kamen filed a suit under §36(b), and Rule 23.1 therefore "does not apply". In *Fox* that meant no demand; here it means no need for adequate representation. See also *Pellegrino v. Nesbitt*, 203 F.2d 463 (9th Cir.

1953) (similar conclusion with respect to the short-swing-profit-recovery provision of §16(b) of the Securities Exchange Act of 1934).

If Rule 23.1 does not require adequate representation, defendants maintain, then the due process clause of the fifth amendment must. Due process requires adequate representation, though, only when the plaintiff is *representing* someone else. A judgment in a class action will bind persons who are not before the court. Before resolving the legal entitlements of missing persons, the court must ensure that they have an effective voice. *Hansberry v. Lee*, 311 U.S. 32, 41-42 (1940). Kamen represents no one other than herself. *Fox* establishes that the right at stake is personal; she does not need the approval of the court or other investors to pursue it. Doubtless other investors are interested in the result, yet many suits affect the status of others as a practical matter without triggering a constitutional requirement of "adequate representation".

Rules 19 and 24 are designed for such cases. Rule 19 allows and sometimes requires the joinder of persons who will be affected by a judgment; Rule 24 allows intervention. Defendants do not maintain that Rule 19 requires the joinder of other investors. Rule 24 may allow them to intervene on the other side to argue for or against Kemper's management fees. *Bethume Plaza, Inc. v. Lumpkin*, 863 F.2d 515, 531-34 (7th Cir. 1988). None has done so, undoubtedly because investors who support the current fee structure believe that they already have adequate champions: Kemper and the Fund. What is more, a judgment against the defendants requiring a reduction in the level of fees would not "bind" other investors any more than a judgment in a contract or tort suit "binds" the

investors and employees of the firm required to pay damages. If the court should deem the fees excessive, and the Fund then cut back on services, shareholders may take their money elsewhere. That would injure the Fund and Kemper, which as parties represent themselves. It might also reduce the consumers' surplus of the investors (the value they place on the Fund's services, less the price they pay), but such an indirect consequence does not require either actual or vicarious representation in the litigation. See *O'Bannon v. Town Court Nursing Center*, 447 U.S. 773, 778-89 (1980).

B

At all events, Kamen is no less adequate a representative than are most plaintiffs in class actions. Securities actions, like many suits under Rule 23, are lawyers' vehicles. Investors diversify their holdings, so it is no surprise that Kamen, like most plaintiffs in securities cases, does not hold very much stock in the defendants and has delegated the investigation and prosecution of the suit to counsel. Class actions are valuable precisely because they allow the vindication of claims too small to prosecute individually but worth litigating in the aggregate. See *In re American Reserve Corp.*, 840 F.2d 487 (7th Cir. 1988). When defendants' counsel took Kamen's deposition and learned that she knew little about either the Fund or the case and had given counsel free reign, they learned only that this case fits the norm. Securities markets function efficiently because of the division of labor; legal markets also rely on specialization. Kamen did not need to immerse herself in the mutual fund business to qualify as a plaintiff. *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363

(1966); *Lewis v. Curtis*, 671 F.2d 779, 788-89 (3d Cir. 1982). Counsel to whom Kamen entrusted the litigation – perhaps more accurately, who found Kamen to wage the litigation – is a specialist in the field, having argued and won *Fox* in the Supreme Court. There can be no doubt that Kamen's champion will advocate the claim vigorously and skilfully [sic].

Magistrate Balog's conclusion that Kamen has only a private grievance misses the point. Kamen is not trying to get even because she bears a grudge – say, because a member of the Fund's board trampled her petunias. She seeks a higher rate of return on her investment. So do all other shareholders in the Fund. It may well be that most other shareholders believe that the Fund's special services are worth the 0.2% cost, but shareholders have a common interest in ensuring that the Fund pays Kemper no more than the extra services are worth. Commonality of interest is the essence of adequate representation. *Sosna v. Iowa*, 419 U.S. 393, 403 (1975). If the services make a 0.2% premium fee "excessive", the defendants will prevail on the merits. If the services do not justify the incremental fee, then all shareholders will gain from a decision.

Given that Kamen and other investors win or lose together, the adequacy of her representation (more realistically, of her lawyer's) matters if the suit is strong. Suppose the Fund has a well-grounded claim against Kemper for $40 million in excessive fees. A feeble litigant, or one willing to sell out for satisfaction of her personal claim, would injure other investors in the Fund by extinguishing the claim against Kemper without producing its full value for the Fund. Other investors therefore could

be worried that the first one to step forward and sue will be insufficiently vigorous, or have divided loyalties. No such investor has appeared to complain that Kamen will do too little for them, and neither the Fund nor Kemper seems worried that Kamen will under-prosecute this suit. Why is it that the *defendants* insist that the plaintiff is a poor representative of the other stockholders? Perhaps defendants fear that Kamen will be too vigorous?

Defendants' principal fear is not of inadequate representation but of legal error – that a court playing rate regulator may think the fees excessive even when they are not. Such a mistake would injure all investors, and the injury would fall more heavily on investors other than Kamen who use the sweeps and redemption services the Fund provides. Kamen would find other money market funds suited to her passive investment strategy; active investors would be especially aggrieved by a cutback in services. In this sense, even though Kamen's interests are the same as those of other investors – all want the fund to pay no more than the market price for the services Kemper renders – Kamen has less to fear from an error and therefore is not the optimal champion. Still, such differences in incentives pervade class actions. Even if the members of the class were perfectly homogeneous (they never are), the representative's small stake might lead her to settle for too little or to press arguments that favored her position (or her attorney's) at the potential expense of those she represents. See Kenneth W. Dam, *Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest*, 4 J. Legal Studies 47 (1975); Andrew Rosenfield, *An Empirical Test of Class-Action Settlement*, 5 J. Legal Studies 113 (1976). Agency costs of this kind, even when coupled

with differential sensitivity to error costs, are not the same as concrete conflict of interest between the "representative" and other members of the class. They inhere in representative actions. The real bogies, the costs of defense and the risk of error, haunt all litigation. False positives and the potential for self-serving conduct are endemic to the system under §36(b); the costs of legal error in regulating prices are attributable to the existence of §36(b) and not to the selection of Kamen as a plaintiff.

Although the investors by majority vote approved Kemper's fees in 1986, the vote was not unanimous. Of the 5.3 billion shares of the Fund's money market portfolio in 1986, 2.97 billion were voted at the meeting (almost all by proxy). Approximately 2.44 billion were voted for the management agreement, 364 million against, and 169 million abstaining. The contract was ratified, then, by 82% of the shares present at the meeting, although only 46% of the outstanding shares. These figures do not suggest that Kamen is in a teensy minority; she had as of 1986 the company of the holders of 364 million shares of the Fund. Section 36(b)(2) provides that investors' approval of a management fee should inform the court's judgment on the merits; it does not imply that approval forecloses suit by one of the dissenters – if it did, §36(b) would be dead, for *all* fees challenged under the statute have been approved by the investors at one or another time. So, too, it is not dispositive that none of the other investors has intervened to support Kamen's suit. Many a class action proceeds with a single representative; conservation on the number of litigants is a virtue of the device. Even if this were a case in which the plaintiff must represent others "adequately", then, Kamen would be a proper plaintiff.

III

Because the action may proceed under §36(b), we need to decide whether Kamen is entitled to a jury trial in the event there are disputed issues of material fact. Judge Nordberg held not, following *In re Evangelist*, 760 F.2d 27 (1st Cir. 1985), *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45 (2d Cir. 1987), and *Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404, 414 (2d Cir. 1989). These opinions hold that the action authorized by §36(b) is not a "suit[ ] at common law" within the meaning of the seventh amendment because the statute creates a fiduciary duty and recovery "shall in no event exceed the amount of compensation or payments received from [the] investment company", §36(b)(3). A combination of fiduciary duty with a remedy of cancellation and restitution is traditionally equitable.

Novel statutes such as §36(b), establishing requirements and procedures that *Fox* repeatedly called "unique", do not fit well into a constitutional framework requiring the rights to jury trial as of 1791 to be "preserved". Federal courts abolished the distinction between law and equity with the adoption of the Rules of Civil Procedure in 1938, and changes in both the nature of legal rights and the preferred remedies make it difficult to reconstruct what our forbears would have seen as "common law". See Douglas G. Baird, *The Seventh Amendment and Jury Trials in Bankruptcy*, 1989 Sup. Ct. Rev. 261. No rights comparable to those of §36(b) existed two centuries

ago; the closest equitable action dealt with corporate "waste" and not with determining whether prices are reasonable. Although enforcing fiduciary duties was equitable in English practice, awarding damages was a job for a common law court. Squeezing a hybrid action into one category or the other is bound to cause friction. Recognizing that no answer can be wholly satisfactory, and not wanting to add unnecessarily to the clutter of opinions on the subject, we adopt both the holding and rationale of *Evangelist*.

One case postdating the First and Second Circuits' decisions calls for comment. *Teamsters Local No. 391 v. Terry*, 110 S. Ct. 1339 (1990), holds that a suit alleging that a union breached its duty of fair representation, and requesting damages measured by the amount of back pay, is "at common law" for constitutional purposes and so allows either side to demand a jury. The Court rejected an argument that the foundation of the suit on a breach of the union's fiduciary duty to its members was sufficient to render it "equitable". Even the fillip that the remedy would be measured by the amount of pay lost, a yardstick from the courts of equity, did not suffice. *Terry* appears to call into question the foundation for *Evangelist* and similar holdings about §36(b).

Although any prediction is hazardous, we conclude that the Court would think an action under §36(b) equitable under the analysis it used in *Terry*. Seven Justices accepted the proposition, central to cases such as *Evangelist*, that "an action by a trust beneficiary against a trustee for a breach of fiduciary duty" is equitable because it was "within the exclusive jurisdiction of the courts of equity" in 1791. 110 S.Ct. at 1346 (plurality opinion); see also *id.* at

1355 (Kennedy, J., dissenting). The investment adviser is not a "trustee", and the relation between fund and adviser is contractual rather than one in which the beneficiary of the trust lacks authority to choose the trustee; still, the statute creates a fiduciary duty and enforces it with a remedy (disgorgement) common in trust cases.

The analogy between the union's duty and a trustee's broke down in *Terry* because the union was supposed to be enforcing a contract, and the claim against the union depended on proof that the employer broke its contract. The remedy, although measured by pay lost, came from the union rather than the employer, which made it look more like damages than restitution. An action under §36(b), quite unlike the action for a breach of the duty of fair representation, is one to annul a contract rather than to enforce it. Reformation or cancellation of a contract was equitable in 1791 and until the distinction between law and equity broke down in this century. Restitution under §36(b) comes from the party that received the benefits, which further separates this case from *Terry*. Four different opinions in *Terry*, advocating four different approaches to the constitutional question, render parlous any predictions. Nonetheless, the combination of a fiduciary duty with a restitutionary remedy in §36(b) continues to put this statute on the equitable side of the constitutional line.

The judgment of the district court is affirmed in part, reversed in part, and remanded for further proceedings on the claim under §36(b).

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

Memorandum Opinion and Order

IN THE
UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 85 C 4587 - Judge John A. Nordberg

JILL S. KAMEN,

Plaintiff,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Defendants.

MEMORANDUM OPINION AND ORDER

The plaintiff, Jill Kamen, is a shareholder in Cash Equivalent Fund, Inc. ("the Fund"), a money market mutual fund managed and administered by Kemper Financial Services, Inc. ("KFS"). Plaintiff instituted this shareholder's derivative action pursuant to the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* ("ICA" or "the Act"), challenging the fees charged by KFS for managing and administering the Fund. She alleges that KFS solicited a misleading proxy in violation of § 20(a) of the Act, 15 U.S.C. § 80a-20(a), and that KFS' excessive fees constitute a breach of its fiduciary duty in violation of § 36(b) of the Act. 15 U.S.C. § 80a-35(b).[1]

[1] This court has jurisdiction pursuant to § 44 of the Act, 15 U.S.C. § 80a-43.

Defendants move to dismiss plaintiff's § 20(a) claims for failure to state a cause of action and for failure to make a demand on the Board of Directors as required by Fed.R.Civ.P. 23.1; and to strike plaintiff's jury demand. For the following reasons, the court grants the motions to dismiss and to strike the jury demand.

Factual Allegations

The facts, as alleged in the complaint,[2] are as follows. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the ICA. It invests in a range of short-term money market instruments with maturities of one year or less. The Fund commenced operations on March 16, 1979, and, as of April 23, 1985, its total assets were approximately $4.683 billion.

KFS has acted as the Fund's investment adviser, manager, primary administrator and underwriter since the Fund's inception. In exchange for its services, KFS receives monthly fees paid under two separate agreements. The investment management agreement provides for an investment management fee calculated at the annual rate of .22 of 1% of the first $500 million of the combined average daily net assets of the portfolios managed by KFS, .20 of 1% of the next $500 million, .175 of 1% of the next $1 billion, .16 of 1% of the next $1 billion

[2] On a motion to dismiss, the court must accept all well pleaded facts as true, and must make all reasonable inferences in the light most favorable to the plaintiff. *Conley v. Gibson*, 355 U.S. 41, 45-46, 78 S.Ct. 99, 102 (1957); *City of Milwaukee v. Saxbe*, 546 F.2d 693, 704 (7th Cir. 1976).

and .15 of 1% of average daily net assets of such portfolios over $3 billion. The administration, shareholder services and distribution agreement ("administration agreement") provides for an annual fee, payable monthly, on a basis of .33% of the first $500 million of average daily net assets, .30% of the next $500 million, .275% of the next $1 billion, .265% of the next $1 billion, and .25% of average daily net assets over $3 billion.

The Fund has experienced tremendous success in attracting shareholder funds in the past several years, which has caused a significant increase in the total fees payable to KFS under the two separate agreements. For the fiscal year ended July 31, 1984, the Fund paid KFS nearly $20 million in fees.[3]

The essence of plaintiff's complaint is that these fees are excessive, given the nature of the Fund and the services performed by KFS. Plaintiff alleges that, unlike other mutual funds, the management of the assets of a money market fund "does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts [because] the assets of the Fund are . . . invested in a relatively concentrated manner in fixed income obligations maturing in one year or less." (Compl. ¶9).[4] Despite the huge growth

[3] Kamen filed a supplemental complaint on December 8, 1986. This complaint alleges that the Fund's Board of Directors amended KFS' administration agreement in November of 1986 to substantially increase the fees paid to KFS.

[4] Paragraph 14 alleges:

Because of the limited number, nature and variety of the Fund's investments, the investment decisions of

(Continued on following page)

of the Fund and the manner in which it is serviced, the fee structure has remained the same since December 1, 1981, when the fees were increased by virtue of the administration agreement. According to Kamen, the increased compensation paid to KFS resulting from the enormous increase in Fund assets is disproportionate to the services rendered by it. These allegations form the basis of Kamen's excessive fee claim under § 36(b) of the Act, 15 U.S.C. § 80a-35(b).

Kamen also alleges that KFS violated § 20 of the ICA, 15 U.S.C. § 80a-20, which proscribes the solicitation of misleading proxies in connection with a security of a registered investment company.[5] In addition to the Fund,

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(Continued from previous page)

the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and 'turning over' money market instruments with a limited number of institutions. The incremental cost to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.

[5] 15 U.S.C. § 80-20(a) provides in pertinent part:

It shall be unlawful for any person, by use of the mails or any means of instrumentality of interstate

(Continued on following page)

KFS also acts as an investment manager to the Kemper Money Market Fund, Inc. ("MM"), a money market fund which is similar to the Fund in size, number of shareholders, and investment objective. MM and the Fund have some common directors, and require substantially the same services from KFS. According to Kamen, despite this similarity in size and objective, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients.[6]

Kamen further alleges that, on or about September 12, 1984, KFS caused a proxy statement to be distributed to the shareholders for the annual meeting of shareholders scheduled for November 8, 1984. One of the purposes of the meeting was to obtain shareholder

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(Continued from previous page)

commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect to any security of which a registered investment company is the issuer in contravention of such rules and regulations of the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 20a-1 renders the rules and regulations promulgated by the SEC pursuant to § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C § 78n. applicable to misleading proxy claims under § 20(a) of the ICA. 17 C.F.R. 270.20a-1.

[6] Kamen alleges that in the Fund's expenses in the year ended July 31, 1984 .72% of its average net assets, while MM's expenses were only .53% of its average net assets. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM. (Compl. ¶ 12).

approval for the continuance of the investment management agreement with KFS. The proxy statement seeking shareholder approval of the investment management agreement compared the fees that KFS received from other investment companies to those paid by the Fund. Kamen alleges that, although the proxy correctly compared, the services rendered to the Fund to those rendered to MM, it "misleadingly" described MM's fees as a maximum fee of .50 of 1% of the first $215 billion [sic], with lesser rates of additional assets." This "misleading" description gave the false impression that MM's fees were as high or higher than those paid by the Fund, when KFS knew that the opposite was actually true. The proxy solicitation was successful, and KFS obtained shareholder approval for continuation of its investment management agreement with the Fund.

As the above allegations clearly demonstrate, the thrust of Kamen's § 20(a) claim is that KFS disseminated misleading proxies in order to obtain continued shareholder approval for allegedly exorbitant fees. KFS' motion to dismiss concerns only the § 20(a) claims. It urges dismissal of this claim on two grounds: first, because Kamen failed to make a demand on the Fund's directors, as required by Fed.R.Civ.P. 23.1; and second, because § 36(b) of the Act provides the exclusive remedy for excessive fees. For the following reasons, the court finds that, although the complaint properly alleges a cause of action under § 20(a), it must be dismissed because Kamen failed to comply with the demand requirements of Rule 23.1.

Claims under § 20 of ICA

KFS argues that ¶ 13 of the complaint, which alleges violations of § 20(a) of the ICA, 15 U.S.C § 81a-20(a), must be dismissed because § 36(b) provides the exclusive remedy for shareholder claims alleging excessive fees. Section 20(a) of the ICA forbids the dissemination of misleading information in proxies solicited from mutual fund shareholders. Section 36(b) of the Act, which was passed in 1970,[7] authorizes a shareholder's suit to recover excessive fees from a fund's investment adviser. Congress added this section in order to remedy the fact that the Act, as originally passed, failed to "provide any mechanism by which the fairness of management contracts [between a fund and its adviser] could be tested in court." S.Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. Code Cong. & Admin. News 4897, 4901. Section 36(b) creates a fiduciary duty on the part of the adviser "with respect to compensation for services or other payments paid by the fund . . . to the advisers," *id.*, and authorizes shareholders to sue for breach of that fiduciary duty. *See generally Daily Income Fund, Inc. v. Fox*, 104 S.Ct. 831 (1984).

Prior to the passage of § 36(b), the Second Circuit had recognized an implied cause of action under the ICA for misleading proxy statements. *See Brown v. Bullock*, 194 F.Supp. 207, 231-34 (S.D. N.Y), *aff'd*, 294 F.2d 415, 420-21 (2d Cir. 1961).[8] It continued to recognize an implied cause

[7] Section 20(a) was part of the original Investment Company Act passed in 1940.

[8] All of the cases discussing an implied right of action under § 20(a) have arisen in the Second Circuit.

of action for § 20(a) claims unrelated to allegations of excessive fees after the passage of the 1970 amendments. *Tannenbaum v. Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934, 98 S.Ct. 421 (1977); *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976); *Rosenfeld v. E.R. Black*, 445 F.2d 1337 (2d Cir. 1971). In *Fogel v. Chestnutt Corp.*, 668 F.2d 100, 112 (2d Cir. 1981), *cert. denied*, 459 U.S. 828, 103 S.Ct. 65 (1982), however, the court noted in dictum that § 36(b) may constitute a shareholder's exclusive remedy for his claims of excessive fees.

Although some district courts seized on the language in *Fogel* to disallow implied claims for excessive fees under the ICA,[9] a recent decision has recognized a claim under § 20(a) of the ICA in a situation involving facts very similar to the case at bar. In *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 622 F.Supp. 169 (S.D. N.Y. 1985), the plaintiff-shareholder alleged that the management fee paid to the fund's adviser was excessive (36(b) claim) and that the defendants violated § 20(a) because the proxies soliciting shareholder approval of the management contract were misleading. The plaintiff sought repayment of the excessive fees under the § 36(b) claim, and sought profits and/or reimbursements for the amounts paid under the agreements obtained through the misleading proxy. *Schuyt*, 622 F.Supp. at 171. The defendants sought dismissal of the § 20(a) claim on the ground that § 36(b)

[9] *See, e.g., Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F.Supp. 1038, 1067 (S.D. N.Y. 1981), *aff'd*, 694 F.2d 923 (2d Cir. 1982), *cert. denied*, 461 U.S. 906, 103 S.Ct. 1877 (1983) (*"Gartenberg I"*); *Tarlov v. Paine Webber Cash Fund, Inc.*, 559 F.Supp. 429, 437 (D. Conn. 1983).

provided the exclusive remedy for plaintiff's excessive fee claims.

The court rejected Rowe Price's argument that Schuyt's § 20(a) claim was " 'an excessive fee claim dressed in slightly different clothes' " *Id.* at 173-74. It noted:

> Count III of the Third Amended Complaint does not allege *solely* that advisory fees paid by the Fund to Price Associates were excessive. The § 20(a) claim raised in Count III advances distinct factual allegations of material non-disclosures in particular proxy statements, and seeks legal and equitable relief beyond the mere recapture of excessive fees. Because it cannot fairly be characterized as a claim that alleges *solely* a breach of fiduciary duty arising from excessive compensation paid to an investment adviser, plaintiff's § 20(a) claim does not fall with the narrow category of claims that the Second Circuit panel in *Fogel v. Chestnutt, supra*, thought might properly be brought only under § 36(b)

Id. at 174 (emphasis in original). In the present case, Kamen has not denominated her claims in separate counts.[10] However, it is clear from the pleadings that she seeks damages for the alleged § 20(a) violation and reimbursement of excessive fees for the § 36(b) claim. The factual allegations of misleading proxy statements are distinct from the fiduciary breach allegations. Both

[10] In this respect, Kamen's complaint fails to satisfy the requirements of Fed.R.Civ.P. 10(b), which requires "that each claim founded upon a separate transaction or occurrence . . . shall be stated in a separate count."

address a distinct form of cupable [sic] conduct separately redressable under the ICA. Following *Schuyt*, the court finds that Kamen should be able to pursue both claims in this lawsuit.

The Supreme Court recently decided a similar issue in *Herman & MacLean v. Huddleston*, 459 U.S. 375, 103 S.Ct. 683 (1983). In that case, the plaintiff alleged that defendants issued a misleading registration statement, and filed suit under § 10(b) of the Securities Exchange Act of 1934 and § 11 of the Securities Act of 1933. The defendants sought dismissal of the implied action under § 10(b) on the grounds that § 11 provided the exclusive remedy for misrepresentations relating to registration statements. The Supreme Court noted that these two provisions involve distinct causes of action, and were intended to address different wrongdoings. Thus, although the evidence supporting the two claims might overlap, this fact, in and of itself, was insufficient to preclude plaintiff from pursuing both claims. 495 U.S. at 381, 103 S.Ct. at 686.

This analysis applies with equal force to KFS' argument that § 36(b) provides the sole remedy for excessive fees. Section 20(a) was enacted in order to ensure complete and adequate disclosures in proxy materials solicited from mutual fund shareholders. Patterned after § 14 of the Securities Exchange Act of 1934, it prohibits dissemination of misleading proxies. In order to recover for a violation of this section, the plaintiff must establish "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of the information available." *TSC Industries, Inc. v. Northway, Inc.*,

426 U.S. 438, 449, 96 S.Ct. 2126, 2133 (1976). In contrast, a plaintiff in a § 36(b) suit must prove a breach of fiduciary duty on the part of the investment adviser. 15 U.S.C. § 80a-35(b)(1). Proof of misrepresentations may assist the plaintiff in his burden of proof, but a plaintiff need not establish the existence of misrepresentations in order to prevail on a § 36(b) claim. To prove a § 36(b) violation, the plaintiff must demonstrate that the adviser charges a fee "that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arms length bargaining." *Gartenberg I*, 694 F.2d at 928. Thus, although a violation of § 20(a) may be relevant to a § 36(b) claim, it clearly exists independent of that claim. *See Schuyt*, 622 F.Supp. at 176-177.[11] Following *Huddleston*, there is no reason to carve out an exception to the well-recognized implied cause of action from misleading proxy statements under § (a) of the ICA.

Contrary to KFS' argument, the legislative history of the passage of § 36(b) does not evidence a Congressional intent to preclude other suits to recover excessive fees based on wrongdoings prohibited by other sections of the

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[11] The court disagrees with KFS's argument that allowing § 20(a) claims in the context of excessive fee suits would thwart the intent of Congress when it passed § 36(b). According to KFS, allowance of a § 20(a) claim would undermine the procedural restrictions contained in § 36(b). What KFS fails to acknowledge is that a § 20(a) claim exists independent of a § 36(b) claim, and involves different elements of proof. Not all § 36(b) claims involve misleading proxies and a plaintiff needs a misrepresentation in a proxy statement if she wishes to proceed under § 20(a).

ICA. In *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 378-79, 102 S.Ct. 1825, 1839 (1982), the Court held that when Congress amends a pre-existing law, the proper inquiry is not whether Congress intended to create a private remedy to supplement the express remedy, but rather, whether "Congress intended to *preserve* the preexisting remedy." (emphasis supplied). Prior to the passage of § 36(b), the courts had recognized an implied right of action for claims related to the procurement of an advisory contract which permits excessive fees. *Brown v. Bullock*, 294 F.2d 415 (2d Cir. 1961). *Cf. J.I. Case v. Borak*, 377 U.S. 426, 84 S.Ct. 1555 (1964) (recognizing an implied cause of action under § 14 of the Securities Exchange Act of 1934). This court agrees with the *Schuyt* court's conclusion that "nothing in the statute or legislative history indicates that Congress intended to preclude a mutual fund shareholder from joining a § 36(b) claim for excessive fees with claims for breach of other fiduciary duties or for other distinct violations of the ICA." *Schuyt*, 622 F.Supp. at 177 (footnote omitted). *See Krome v. Merrill Lynch & Co., Inc.*, 637 F.Supp. 910, 917-20 (S.D. N.Y. 1986); Note, *Implied Private Rights of Action under the Investment Company Act of 1940*, 40 Wash. & Lee L.Rev. 1069, 1085-86 (1983).

KFS relies primarily on *Gartenberg I* to support its argument that § 36(b) provides the exclusive remedy for excessive fee claims. *Gartenberg I* provides little support for the argument that § 20(a) claims cannot be joined with claims under § 36(b). In *Gartenberg I*, the plaintiff did not raise the issue of alleged violations of § 20(a) until after the court had completed a bench trial on his § 36(b) claims. This district court dismissed this belated claim

because the alleged misstatements were not misleading. 528 F.Supp. at 1066. It added, "[i]n any event, . . . § 20(a) of the Act w[as] not intended to and do[es] not establish a private right of action in the context of a claim such as here for recovery of compensation under § 36(b)." *Id.* at 1067. On Appeal, the Second Circuit affirmed the District Court's findings with respect to Gartenberg's § 36(b) claims. 694 F.2d at 930-33. The court also affirmed the district court's dismissal of the belated § 20(a) claims because they were not properly before the district court for adjudication. It added, "[i]n any event, for the reasons already expressed by us and the additional reasons stated by the district court in its discussion of these additional claims, . . . they are meritless." 694 F.2d at 934.

The *Gartenberg* plaintiffs filed a second case after the Second Circuit issues its decision in *Gartenberg I*. *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 573 F.Supp. 1293 (S.D. N.Y. 1983), *aff'd*, 740 F.2d 190 (2d Cir. 1984) (*"Gartenberg II"*). In *Gartenberg II*, the plaintiffs raised claims under both § 20(a) and § 36(b). The case was assigned to the same district judge who tried *Gartenberg I*. It is noteworthy that this judge tried both claims, without mention of his statement in *Gartenberg I* that § 36(b) might preclude § 20(a) claims based on misleading proxies used to authorize excessive fees. *Gartenberg II*, 573 F.Supp. at 1307 (discussing merits of § 20(a) claim). The *Gartenberg II* affirmance also fails to refer to the court's earlier statement that § 36(b) precludes § 20(a) claims in this type of case.

In *Schuyt*, the court noted the same distinction between the treatment of § 20(a) claims in *Gartenberg I* and *Gartenberg II*. It concluded:

> [The District Court's] strikingly different treatment of the two § 20(a) claims raised in *Gartenberg II* strongly suggests that his rejection at [the] § 20(a) claim in *Gartenberg I* and *II* resulted from the defects peculiar to that claim and not from a defect generic to all § 20(a) claims joined with a claim for excessive fees.

Schuyt, 622 F.Supp. at 176.[12] This court agrees that the court's comments in *Gartenberg I* must be viewed in the context of that case. Given the Second Circuit's acknowledgment of § 20(a) claims after *Gartenberg I*, the court finds that this case provides scant support to KFS' argument that § 20(a) claims can never be raised in connection with a § 36(b) suit for excessive fees.

For the reasons set forth above, the court finds that the passage of § 36(b) does not preclude a claim under § 20(a) which alleges that the management contract was secured through a misleading proxy. Therefore, the court denies KFS' motion to dismiss Kamen's § 20(a) claim for failure to state a cause of action.

Rule 23.1's Demand Requirement

This complaint was filed as a shareholder's derivative action in which Kamen seeks to sue on behalf of the Fund to recover excessive fees allegedly paid to KFS. Rule 23.1, which governs derivative actions, provides:

[12] The court notes that the Second Circuit has issued another decision subsequent to *Gartenberg II* which allowed § 20(a) claims without mention of the possible limitation imposed by § 36(b). *See Meyer v. Oppenheimer Management Corp.*, 764 F.2d 76 (2d Cir. 1985).

> In a derivative action brought by [a] shareholder . . . to enforce a right of a corporation, . . . having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors, . . . and the reasons for his failure to obtain the action or for not making the effort.

In *Daily Income Fund, Inc. v. Fox*, 104 S.Ct. 831, 841 (1984), the Supreme Court held that Rule 23.1's demand requirement is inapplicable to shareholder suits challenging excessive advisory fees under § 36(b). KFS acknowledges that Kamen's § 36(b) claims cannot be dismissed for noncompliance with Rule 23.1; however, it urges the court to dismiss the § 20(a) claims, which are not implicated by the *Fox* decision, because Kamen failed to make a demand on the Fund's Board of Directors in accordance with Rule 23.1.

The purpose of Rule 23.1's demand requirement is to notify directors of a potential claim, so that they may investigate it and pursue intracorporate remedies before a court intervenes at a shareholder's request. *Thornton v. Evans*, 692 F.2d 1064, 1080 (7th Cir. 1982); *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D. Ill. 1981). The demand requirement stems from the recognition that "derivative actions brought by minority stockholders could, if unconstrained, undermine the basic principle of corporate governance that the decisions of a corporation – including the decision to initiate litigation – should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox*, 104 S.Ct. 831, 836 (1984). Rule 23.1's limitations are "designed to limit the use of the

[shareholders' derivative suit] to situations in which, due to an unjustified failure of the corporation to act for itself, it [is] appropriate to permit a shareholder 'to institute and conduct litigation which usually belongs to the corporation.'" *Id.*, citing *Hawes v. City of Oakland*, 104 U.S. 450, 460, 26 L.Ed. 827 (1882).

The rationale underlying Rule 23.1's demand requirement is two-fold: first, the courts presume that management is in a superior position to assess the merits of a particular claim; and second, assuming the claim is valid, the corporation may possess superior financial resources with which to pursue the litigation. *Lewis v. Anselmi*, 564 F.Supp. 768, 771 (S.D. N.Y. 1983); *Abrams v. Mayflower Investors, Inc.*, 62 F.R.D. 361, 369 (N.D. Ill. 1974). The "futility" exception to the demand requirement recognizes that there are circumstances where a demand would be a useless gesture, given the relationship between the board of directors and the alleged illegal transaction. Accordingly, Rule 23.1 permits a court to excuse the failure to make a demand if the plaintiff alleges with particularity specific circumstances which indicate that the directors would have ignored her complaints or refused to take any action on them. *See generally Nussbacher v. Continental Illinois National Bank & Trust Co. of Chicago*, 518 F.2d 873, 875 (7th Cir.), *cert. denied*, 424 U.S. 928, 96 S.Ct. 1142 (1976) (plaintiff's failure to make formal demand excused because plaintiff was told directly that the directors would not assist her in any way); *In re Kauffman Mutual Funds, Inc.*, 479 F.2d 257, 264-65 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161 (1973) (allegations of self-interest or bias may excuse demand); *Untermeyer v. Fidelity Daily Income Trust*, 79 F.R.D. 36, 42 (D.

Mass.), *vacated*, 580 F.2d 22 (1st Cir. 1978) (plaintiff should allege facts which show an "unmistakeable antagonism between the trustees and the corporate interests").

It is undisputed that Kamen failed to make a demand on the Fund's Board of Directors. Although the original complaint did not provide any excuse for this non-compliance with Rule 23.1, Kamen has corrected this error by filing an amended complaint which alleges that resort to the Fund's Board of Directors was not attempted because it would have been futile. Paragraph 17 of the Amended Complaint alleges the following facts in support of Kamen's futility claim:

> (a) With respect to the claims asserted under § 36(b) of the Act, no such demand is required;
>
> (b) The board of directors of the Fund consists of ten members. Of these, three are "interested" as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called "non-interested" directors currently receive aggregate remuneration of approximately $300,000 a year for serving as directors of the Fund and of all of the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;
>
> (c) The proxy statement referred to in paragraph 13 above stated: "the accompanying proxy is solicited by the Board of Directors of the Fund . . . ", and indeed, the directors did vote, without dissent, to distribute the proxy statement to Fund shareholders. Any suit, such as the instant suit, brought to establish liability for the material false statements contained in

that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund;

(d) Requiring the plaintiff to make a demand on the Fund or its directors to institute or prosecute this action would be futile. It would be tantamount to asking the directors to sue themselves. Moreover, were the directors to accept such an invitation and institute an action, the prosecution of the action would be in hostile hands inimical to its success;

(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;

(f) In responding to the original complaint, the Fund, both in its answer and motion to dismiss, has sought the dismissal of the complaint on substantive grounds;

(g) Under all of the circumstances present in this case, application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act.

The court finds that, although subsection (a) correctly explains the applicability of Rule 23.1 to the § 36(b) claim, subsections (b) through (g) are insufficient to satisfy the pleading requirements of Rule 23.1.

Rule 23.1 requires a plaintiff to allege facts excusing her failure to make a demand "with particularity." This requirement " 'represents a deliberate departure from the relaxed policy of notice pleading promoted elsewhere in the Federal Rules.' " *Grossman v. Johnson*, 89 F.R.D. 656, 659 (D. Mass. 1981); *aff'd.* 674 F.2d 115 (1st Cir.), *cert. denied*, 459 U.S. 838, 103 S.Ct. 85 (1982) (*quoting Heit v. Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977)). *See also Kaufman v. Kansas Gas & Electric Co.*, 634 F.Supp. 1573, 1578 (D. Kan. 1986) (holding plaintiff to strict pleading requirements); *Adkins v. Tony Lama Co., Inc.*, 624 F.Supp. 250, 255 (S.D. Ind. 1985) (conclusory allegations of "futility" insufficient); *Kaufman v. Safeguard Scientifics, Inc.*, 578 F.Supp. 486, 489 (E.D. Pa. 1984) (Rule 23.1 requires "meticulous specification" of the facts surrounding plaintiff's failure to make a demand). As the following discussion illustrates, Kamen's generalized allegations of futility have been consistently rejected by the courts as inadequate under Rule 23.1.

Subsection (b) describes the composition of the Fund's ten-member board of directors. Kamen admits that only three of these directors are "interested" under the Act.[13] The remaining seven members of the board are

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[13] The ICA provides that "No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company." 15 U.S.C. § 80a-10(a). Section 2(19) of the Act defines an interested person as follows:

(19) "Interested person" of another person means –

(A) when used with respect to an investment company

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(Continued on following page)

presumably "non-interested" directors.[14] The mere fact that the directors receive substantial remuneration for

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(iii) any interested person of any investment adviser of or principal underwriter for such company.

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer. . . .

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the imm [sic]

(v) [sic] any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer. . . .

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso;. . . .

15 U.S.C. § 80a-2(19).

[14] Plaintiff also alleges that the president of the Fund is a former president of KFS and a stockholder of KFS's parent, Kemper Corporation. The court questions the relevance of this

(Continued on following page)

acting as directors does not, in and of itself, establish that they could not impartially review the merits of Kamen's excessive fee claim. If the fact that a director is paid for his services was sufficient to avoid Rule 23.1, Rule 23.1 would be rendered ineffective.

Furthermore, the fact that these directors assisted KFS in soliciting the allegedly misleading proxy statement does not obviate Kamen's duty to make a demand. The courts have consistently held that "mere approval of challenged conduct is insufficient to render the demand futile." *Lewis v. Anselmi,* 564 F.Supp. 768, 772 (S.D. N.Y. 1983); *Adkins v. Tony Lama Co., Inc.,* 624 F.Supp. 250, 255 (S.D. Ind. 1985); *Lewis v. Valley,* 476 F.Supp. 62, 64 (S.D. N.Y. 1979). *See generally Lewis v. Graves,* 701 F.2d 245, 248-249 (S.D. N.Y. 1983), and cases cited therein. As the First Circuit aptly remarked, "It does not follow . . . that a director who merely made an erroneous business judgment in connection with what was plainly a corporate act will 'refuse to do [his] duty in behalf on [sic] the corporation if [he] were asked to do so.' Indeed, to excuse demand in these circumstances – majority of the board approval of an allegedly injurious corporate act – would

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information on the issue of a demand, since plaintiff does not allege that Hawkinson is even a member of the Fund's Board of Directors. The fact that an *officer* of the Fund had a former affiliation with KFS does not have any bearing on the number of "interested" directors because he would only participate in the Board's decision to pursue the action if he were a *director* of the fund.

lead to serious dilution of Rule 23.1" *In re Kauffman Mutual Funds, Inc.*, 479 F.2d at 265 (citation omitted).[15]

Subsections (d) and (e) state no facts; they merely reiterate Kamen's conclusion of futility based on her conclusory claim that the entire Board is under the control of KFS and Kemper Corporation, its parent. Rule 23.1 requires Kamen to *particularize* her allegations of control. Kamen's complaint implicitly admits that the Board is composed of at least six disinterested directors. She has not presented the court with any information indicating that these directors are incapable of exercising independent judgment or that the three "interested" directors somehow control the outcome of all the Board's decisions. *See Kauffman*, 479 F.2d at 266. A plaintiff's mere speculation that the majority of the board would refuse to take corporate action is insufficient to satisfy Rule 23.1 *Nussbacher*, 518 F.2d at 879 (7th Cir. 1976); *Adkins v. Tony Lama Co., Inc.*, 624 F.Supp. 250, 256 (S.D. Ind. 1985).

In subsection (e) Kamen alleges that demand should be excused because the Fund has moved to dismiss the complaint on substantive grounds.[16] The futility of a

[15] The demand would not be excused even if Kamen had named the individual directors in her complaint. The courts have uniformly held that, absent allegations of bias or self-interest, naming the individual directors cannot obviate the demand requirement of Rule 23.1 *See generally Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983); *Lewis v. Curtis*, 671 F.2d 779, 785 (3d Cir.), *cert. denied*, 459 U.S. 880, 103 S.Ct. 176 (1982); *Lewis v. Sporck*, 612 F.Supp. 1316, 1322 (N.D. Cal. 1985); *Kaufman v. Safeguard Scientifics, Inc.*, 587 F.Supp. 486, 489 (E.D. Pa. 1984).

[16] The Fund has joined Kemper in its motion to dismiss Kamen's § 20(a) claim for failure to make a demand and for failure to state a cause of action.

demand should be gauged at the time the suit is commenced. *Grossman v. Johnson*, 674 F.2d 115, 123 (1st Cir.), *cert. denied*, 459 U.S. 838, 103 S.Ct. 85 (1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129, 99 S.Ct. 1048 (1979); *Shlensky v. Dorsey*, 574 F.2d 131, 142 (3d Cir. 1978); *Seidel v. Public Service Co. of New Hampshire*, 616 F.Supp. 1342, 1350 (D. N.H. 1985). "It is clear that 'the filing of the complaint cannot be regarded as a demand to sue, for by starting the action [plaintiff has] . . . usurped the field.' " 7C Wright, Miller & Kane, *Federal Practice & Procedure* § 1831, quoting *Lucking v. Delano*, 117 F.2d 159, 160 (6th Cir. 1941). The fact that a corporation resists the suit or demands that the requirements of Rule 23.1 be met is insufficient to establish that the board would reject a demand if the plaintiff-shareholder had requested it to act. *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 527 (S.D. N.Y. 1981); *Grossman v. Johnson*, 89 F.R.D. 656, 659 (D. Mass. 1981). Kamen thrust the Fund into an adversary role when she instituted this action. She cannot use the fact that the Fund defended itself in this lawsuit to justify her own failure to comply with Rule 23.1 in the first place.

The demand requirement is a necessary prerequisite to all suits under Rule 23.1.[17] As the court in *Lewis v. Anselmi* noted,

[17] This court echoes the Seventh Circuit's query in *Nussbacher*: "It may be wondered why counsel would not almost routinely take the course of making a formal demand, diligently and in good faith, and in so doing inform the board adequately of the basis of the claim he was asking them to enforce." 518 F.2d at 877.

> Rule 23.1 represents a strong statement of public policy which this court is bound to enforce. It has its historical origin in a perceived evil, the maintenance of strike suits by minority shareholders which impede corporate management at great cost and to little purpose except the enrichment of counsel, coupled also with unnecessary interference by outsiders with internal corporate affairs, which should have been administered at least in the first instance by those elected by the shareholders to do so.

564 F.Supp. 768, 772 (S.D. N.Y. 1983). The court finds that Kamen's generalized allegations of futility, unsupported by any specific facts, are insufficient to excuse her failure to approach the Fund's Board of Directors before she filed this lawsuit. Accordingly, the court dismisses Kamen's § 20(a) claim for failure to comply with Rule 23.1.

Motion To Strike Jury Demand

The dismissal of Kamen's § 20(a) claim does not affect her § 36(b) claim, which KFS apparently concedes is sufficient for the purposes of Fed.R.Civ.P. 12(b)(6).[18] In addition to the dismissal of the Section 20(a) claim, KFS' motion also seeks to strike Kamen's jury demand on the ground that the Seventh Amendment's right to jury "in actions at law" does not extend to § 36(b) claims, which are essentially equitable in nature.

Section 36(b) of the ICA, 15 U.S.C. § 80a-35(b), creates a cause of action on behalf of a security holder of an

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[18] KFS recently filed a motion for summary judgment on the issue of whether Kamen can fairly and adequately represent the other shareholders in this action.

investment company to recover excessive fees paid to the investment company's advisor. Subsection (3) of the Act limits this cause of action by providing:

> No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from breach of fiduciary duty and *shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.*

15 U.S.C. § 80a-35(b)(3) (emphasis supplied). The Seventh Circuit has never discussed the right to a jury trial in the context of a Section 36(b) action. To the court's knowledge, only two circuits have addressed the issue, both concluding that a plaintiff in these actions is not entitled to a jury trial on his Section 36(b) claims. *See In re Evangelist*, 760 F.2d 27, 29-30 (1st Cir. 1985); *In re Gartenberg*, 636 F.2d 16, 17-18 (2d Cir. 1980); *cert. denied*, 451 U.S. 910, 101 S.Ct. 1979 (1981). *See also Weissman v. Alliance Capital Management Corp.*, 84 Civ. 8904 slip op. at 5-6 (S.D. N.Y. Nov. 26, 1985), *pet. for mandamus denied sub nom. In re Weissman*, No. 85-3078 (2d Cir. February 5, 1986); *Tarlov v. Paine Webber Cashfund, Inc.*, 559 F.Supp. 429, 441 (D. Conn. 1983); *Jerozal v. Cash Reserve Management, Inc.*, [1982-83 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 99,019 at 94,827 (S.D. N.Y.1982); *Markowitz v. Brady*, 90 F.R.D. 542, 547-48 (S.D. N.Y. 1981).

These courts all reason that, since § 36(b) involves a claim for breach of fiduciary duty and limits damages to restitution of excessive fees, the action is essentially in equity and therefore not covered by the Seventh Amendment. *Evangelist, supra; Gartenberg, supra.* In the present case, Kamen's Section 36(b) claim is identical to those addressed in the cases listed above. She has not presented the court with any authority rejecting the analysis of the First and Second Circuits on this narrow issue.[19] This

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[19] Kamen argues that § 36(b)'s reference to "damages," and her request for "damages" renders her claim an action at law. This argument has been rejected by every court that has considered it. With respect to the fact that the statute uses the word "damages," the *Gartenberg* court held:

> [I]t seems likely from the context that Congress was using 'damages' merely as a shorthand for 'recovery of money,' not as a legal term of art. Since . . . not all claims for monetary relief are legal in nature, the use of the term 'damages' is not persuasive in this instance. In particular, given the repeated statement in the legislative history that actions under 36(b) are equitable, to be administered on equitable standards, it would seem impossible to conclude from the use of the word 'damages' that Congress thereby provided for a trial by jury.

Gartenberg v. Merrill Lynch Asset Management, Inc., 487 F.Supp. 999, 1006 (S.D. N.Y.), *mand. denied sub nom. In re Gartenberg*, 636 F.2d 16 (2d Cir. 1980), *cert. denied*, 451 U.S. 910, 101 S.Ct. 1979 (1981). *See also In re Evangelist*, 760 F.2d 27, 30 (1st Cir. 1985).

Although the *Evangelist* court was unequivocal in its denial of a right to a jury trial, the *Gartenberg* court qualified its decision in the last paragraph: "Our decision is limited, of course, to the facts of this case. We leave for another day a determination as to the right of a jury trial of a plaintiff making

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court agrees with the controlling weight of authority that Section 36(b) creates restitutionary relief for fiduciary breach, which is traditionally addressed by the courts of equity.[20] Accordingly, the court finds that plaintiff has no

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a bona fide claim for damages." *In re Gartenberg*, 636 F.2d at 18. Kamen argues that because her complaint seeks damages, she falls within this *Gartenberg* caveat. The Second Circuit has never explained his final comment to its opinion; however, the court finds that Kamen's Section 36(b) claim is no different than that advanced in *Gartenberg*. The fact that her complaint requests "damages" does not automatically render her claim an action at law. As the *Evangelist* court noted,

> [I]n our view, the right to jury trial cannot turn on the simple substitution of a different word. *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 477-78 (1962) ('the constitutional right to a trial by jury cannot be made to depend on the choice of words used in the pleadings.). . . . Otherwise, any equitable action for money, say for restitution, could become a legal action by the use of the word 'damages' in place of the word 'restitution.'

760 F.2d at 31. The semantics of Kamen's complaint cannot reign over the substance of her Section 36(b) claim, which is an action seeking restitution for excessive fees paid to KFS.

[20] Kamen also argues that Section 44 of the ICA, 15 U.S.C. § 80a-44, refutes KFS' argument regarding the availability of jury trials in § 36(b) suits. Section 44 confers jurisdiction on the federal courts over "all suits in equity and actions at law brought to enforce any liability or duty created by" the ICA, and authorizes the SEC to "intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoin any non-compliance with, Section 36(b) . . . " Kamen maintains that these provisions indicate that actions under § 36(b) can be characterized as suits at law, thereby entitling her to a jury

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right to jury trial for his § 36(b) claims, and grants KFS' motion to strike Kamen's jury demand.

Conclusion

In the present case, although Kamen alleged sufficient facts to state a claim under § 20(a), she failed to comply with Rule 23.1's important demand requirement, and her proffered excuse for this non-compliance is insufficient to satisfy the futility exception to the rule. Accordingly, the court dismisses Kamen's § 20(a) claim for failure to make a demand on the Fund's Board of Directors. In addition, the court finds that Kamen is not entitled to a jury trial on her § 36(b) claim, and grants KFS' motion to strike her jury demand.

ENTER:

/s/ JOHN A. NORDBERG
JOHN A. NORDBERG
United States District Judge

Dated: February 2, 1987

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trial. As KFS correctly notes, however, this language merely permits the SEC to intervene in § 36(b) actions; it does not change the equitable nature of the action or the remedy that the plaintiff seeks. The gist of an action under § 36(b) is a suit for an accounting, and the remedy is limited by statute to restitution of the excessive fees paid. Under the circumstances, this action is properly characterized as one in equity, in which Kamen is not entitled to a jury trial.

Minute Order From
(rev 4/illegible)

ORDER DATED MARCH 11, 1987
DENYING RECONSIDERATION

UNITED STATES DISTRICT COURT, NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

Name of Assigned Judge Nordberg

Sitting Judge if Other Than Assigned Judge

Case Number 85 C 4587 Date March 11, 1987

Case Title Kamen v. Kemper Financial Services

MOTION: (In the following box (a) indicate the party filing the motion, e.g., plaintiff, defendant, 3d-party plaintiff, and (b) state briefly the nature of the motion being presented.)

Plaintiff's motion for reconsideration of this court's February 2, 1987 order

DOCKET ENTRY:

(The balance of this form is reserved for notations by court staff.)

(1) x Judgment is entered as follows:

(2) ___ (Other docket entry:)

The court denies plaintiff's motion for reconsideration.

(3) ___ Filed motion of [use listing in "MOTION" box above].

(4) ___ Brief in support of motion due _____

(5) ___ Answer brief to motion due _______. Reply to answer brief due _____

(6) ___ ___ Hearing
___ Ruling on _____ set for _____ at _____

(7) ___ Status hearing ___ held ___ continued to ___ set for ___ re-set for ___ at _____.

(8) ___ Pretrial conference ___ held ___ continued to ___ set for ___ re-set for _____ at _____.

(9) ___ Trial ___ set for ___ re-set for _____ at _____.

(10) ___ ___ Bench trial ___ Jury trial ___ Hearing held and continued to _____ at _____.

(11) ___ This case is dismissed ___ without ___ with prejudice and without costs ___ by agreement ___ pursuant to ___ FRCP 4(j) (failure to serve) ___ General Rule 21 (want of prosecution) ___ FRCP 41(a)(1) ___ FRCP 41(a)(2)

(12) x [For further detail see xx order on the reverse of ___ order attached to the original minute order form]

___ No notices required.

___ Notices mailed by judge's staff.

___ Notified counsel by telephone.

x Docketing to mail notices.

___ Mail AO 450 form.

EP courtroom deputy's initials

FILED - ED3
1987 MAR 11 P 4:21

Date/time received in central Clerk's Office

4	number of notices	
MAR 12 1987	date docketed	
ETV	docketing dpty. initials	
MAR 12 1987	date mid. notices	Document # 72
ETV	mailing dpty. initials	

(Reserved for use by the Court)

ORDER

On Feburary 2, 1987, this court held that the plaintiff, Jill Kamen, could state an implied right of action under § 20 of the Investment Company Act; that her § 20 claim is a derivative claim which must be dismissed for failure to comply with the demand requirement of Rule 23.1; and that she is not entitled to a jury trial on her claims arising under § 36(b) of the Act. In the present motion, Kamen requests the court to reconsider its conclusion with respect to the demand requirement and the right to a jury trial under Section 36(b) of the ICA. For the reasons set forth below, the court adheres to its February 2, 1987 rulings on both these issues, and denies Kamen's motion for reconsideration.

In support of her motion for reconsideration with respect to Rule 23.1's demand requirement, Kamen has filed excerpts from the depositions of six of the independent directors in which these directors expressed their present opinions of the merits of Kamen's suit. According

to Kamen, these excerpts establish that the directors would not have prosecuted this action, and that a demand would have been futile. The court rejects this argument for two reasons. First, the futility of the demand is not gauged by the fact that they would not file the suit, it is gauged by a determination of whether the directors are sufficiently detached and independent that they could exercise sound business judgment in responding to the plaintiff's complaint. Although the deposition transcripts indicate that the directors presently do not agree with Kamen, they do not indicate that the directors would not have thoroughly investigated the complaint to determine whether the corporation should institute action against KFS or attempt to restructure its fee arrangement with KFS. None of the directors testified that they would have ignored Kamen's request if she had presented it to them before filing suit.

Second, as this court held in its February 2, 1987 memorandum opinion and order,

> The futility of a demand should be gauged at the time the suit is commenced. *Grossman v. Johnson*, 674 F.2d 115, 123 (1st Cir.), *cert. denied*, 459 U.S. 838, 103 S.Ct. 85 (1982); *Cramer v. GTE Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129, 99 S.Ct. 1048 (1979). . . . The fact that a corporation resists the suit or demands that the requirements of Rule 23.1 be met is insufficient to establish that the board would reject a demand if the shareholder had requested it to act.

Memorandum Opinion at 19. (other citations omitted). The futility of the demand should be demonstrated at the time the case was filed because that is the time that the

shareholder decided to bypass the board of directors and file suit on her own. Once a plaintiff has taken the decision away from the directors, one would expect the directors to formulate some views on the propriety of the litigation. However, the mere fact that the directors indicate their disagreement with the lawsuit after it is filed does not indicate that they would not have considered a timely demand. Therefore, the court denies plaintiff's motion for reconsideration with respect to the dismissal for failure to comply with rule 23.1's demand requirement.

Plaintiff's argument with respect to the jury demand presents the same argument considered and rejected in this court's February 2, 1987 opinion. *See* pp. 20-23. The court denies the motion to reconsider this ruling.

Order

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604

March 30, 1987

By the Court:

Jill S. Kamen,

Petitioner,

No. 87-1455

v.

Honorable John A. Nordberg, United States District Judge of the District Court for the Northern District of Illinois, Eastern Division,

Respondent.

Petition for Writ of Mandamus

This matter comes before the court for its consideration of the "Petition for Writ of Mandamus" filed herein on March 24, 1987 by counsel for the petitioner.

On consideration thereof,

It Is Ordered that counsel for Kemper Financial Services, as a respondent to the petition under Rule 21(b), Fed. R. App. P., shall file a response to this petition by April 9, 1987. By that same date, petitioner shall file a supplemental memorandum addressing the applicability to this case of our decision in *First National Bank of Waukesha v. Warren*, 796 F.2d 999 (7th Cir. 1986).

Order Denying Petition for Writ of Mandamus

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604

April 13, 1987

Before

Hon. Joel M. Flaum, *Circuit Judge*
Hon. Frank H. Easterbrook, *Circuit Judge*
Hon. Daniel A. Manion, *Circuit Judge*

Jill S. Kamen,

Petitioner,

No. 87-1455

v.

Honorable John A. Nordberg, United States District Judge of the District Court for the Northern District of Illinois, Eastern Division,

Respondent.

Petition for Writ of Mandamus

This matter comes before the court for its consideration upon the following documents:

1. The "Petition for Writ of Mandamus" filed herein on March 24, 1987.

2. The "Petitioner's Supplemental Memorandum" filed herein on April 9, 1987.

3. The "Kemper Financial Services, Inc.'s Answer to the Petition for Writ of Mandamus" filed herein on April 9, 1987.

On consideration thereof,

IT IS ORDERED that the "PETITION FOR WRIT OF MANDAMUS" is DENIED. *First National Bank of Waukesha v. Warren*, 796 F.2d 999 (7th Cir. 1986).

Order

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

April 28, 1987

By the Court:

JILL S. KAMEN,

Petitioner,

No. 87-1455

v.

HONORABLE JOHN A. NORDBERG, United States District Judge of the District Court for the Northern District of Illinois, Eastern Division,

Respondent.

Petition for Writ of Mandamus

Judge Flaum has recused himself from participation in this appeal and withdraws his vote on the court's order of April 13, 1987. That order will stand on the votes of Judge Easterbrook and Judge Manion. The petitioner's request for rehearing *en banc* is still pending.

Order Denying Rehearing

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Chicago, Illinois 60604

May 19, 1987

Before
HON. FRANK H. EASTERBROOK, *Circuit Judge*
HON. DANIEL A. MANION, *Circuit Judge*

No. 87-1455

In the Matter of:

JILL S. KAMEN,

Petitioner.

Petition for Writ of Mandamus

ORDER

Petitioner filed a petition for rehearing and suggestion of rehearing en banc on April 24, 1987. At the request of a member of the panel, the petition was circulated to the full court. See OPERATING PROCEDURE 1(a)(2). No judge in regular active service has requested a vote on the suggestion of rehearing en banc, and both of the judges on the panel have voted to deny rehearing. The petition for rehearing is therefore DENIED. Circuit Judge Flaum did not participate in the consideration of or decision on this petition.

DECISION OF THE U.S. SUPREME COURT OF MARCH 7, 1988
DENYING PETITION FOR WRIT OF CERTIORARI

SUPREME COURT OF THE UNITED STATES

Jill S. KAMEN v. John A. NORDBERG, Judge United States District Court for the Northern District of Illinois (Kemper Financial Services, Inc., et al., Real Parties in Interest). No. 86-2070.

On petition for writ of certiorari to the United States Court of Appeals for the Seventh Circuit.

March 7, 1988. The petition for a writ of certiorari is denied.

Justice WHITE, dissenting.

The issue here is when mandamus relief will be available to a party who claims that the District Court wrongly deprived him of the right to a jury trial. Petitioner is a shareholder in a mutual fund and brought a derivative suit against the two companies that administer the fund, alleging breach of fiduciary duty under § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 50a-35(b). The District Court granted defendants' motion to strike petitioner's demand for a jury trial on this claim and petitioner sought mandamus from the Court of Appeals to compel the District Court to honor his demand for a jury trial. The Seventh Circuit denied relief in an order, *Kamen v. Kemper Financial Services, Inc.*, Civ. Action No. 87-1455 (CA7, Apr. 13, 1987), citing its prior decision in *First Nat'l Bank v. Warren*, 796 F.2d 999 (CA7 1986).

In *Warren*, the Seventh Circuit held that mandamus will lie to enforce a party's demand for a jury trial only when, first, the party's right to a jury trial is clear and

indisputable and, second, the party has no other adequate means to attain the relief he desires. 796 F.2d at 1006. The second point is especially critical because it will prevent interlocutory review of many requests for a writ of mandamus to direct the granting of a jury trial, as in many cases the petitioning party can seek this same relief on appeal from the ultimate resolution of the case in the trial court. This decision conflicts with the decisions of other Courts of Appeals, which hold that mandamus relief is available to review an order denying a claimed right of trial by jury, and that a proper petition for mandamus in these circumstances obliges the Court of Appeals to address the merits of the claimed right to a jury trial. *In re Union Nacional de Trabajadores*, 502 F.2d 113, 115-116 (CA1 1974), vacated on other grounds, 527 F.2d 602 (1975); *Lee Pharmaceuticals v. Mishler*, 526 F.2d 1115, 1116-1117 (CA2 1975) (*per curiam*); *Eldredge v. Gourley*, 505 F.2d 769, 770 (CA3 1974); *General Tire & Rubber Co. v. Watkins*, 331 F.2d 192, 194 (CA4), cert. denied, 377 U.S. 952, 84 S.Ct. 1629, 12 L.Ed.2d 498 (1964); *Black v. Boyd*, 248 F.2d 156, 159-161 (CA6 1957); *In re Vorpahl*, 695 F.2d 318, 319 (CA8 1982); *Owens-Illinois, Inc. v. U.S. District Ct.*, 698 F.2d 967, 969 (CA9 1983); *In re Zweibon*, 565 F.2d 742, 745-746 (CADC 1977) (*per curiam*). It may also be inconsistent with this Court's prior decisions in *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 79 S.Ct. 948, 3 L.Ed.2d 988 (1959), and *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 82 S.Ct. 894, 8 L.Ed.2d 44 (1962), which emphasize the responsibility of the Courts of Appeals to grant mandamus relief where it is necessary to protect the constitutional right to trial by jury. I would grant certiorari to resolve the split among the Circuits on this issue.

REPORT AND RECOMMENDATION OF
MAGISTRATE BALOG
DATED APRIL 21, 1989

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff, v. KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC., Defendant.	)	85 C 4587

TO: HONORABLE JOHN A. NORDBERG, JUDGE
UNITED STATES DISTRICT COURT

HONORABLE SIR:

REPORT AND RECOMMENDATION
of Magistrate James T. Balog

Before the court is the motion of defendant Kemper Financial Services, Inc., ("Kemper") for summary judgment on the issue of the adequacy of plaintiff Jill S. Kamen as a representative of the class of shareholders in Cash Equivalent Fund, Inc.

The plaintiff brings this action as a representative of all shareholders in Cash Equivalent Fund, Inc. ("Fund"), a money market mutual fund managed and administered by Kemper. Plaintiff claims that the fees charged by Kemper for management and administration are excessive,

and constitute a breach of its fiduciary duty under §36(b) of the Investment Company Act ("Act"). 15 U.S.C. §80a-35(b). Basically, plaintiff contends that the Fund involves a limited number and variety of investments, and should not require extensive management. She further contends that increased compensation to Kemper has resulted from an enormous increase in the Fund's assets. Plaintiff claims that the fee structure is simply disproportionate to the services Kemper renders.

Kemper's motion for summary judgment does not attack plaintiff's allegations, but is limited to the contention that she is not a proper representative of the shareholder, and therefore is without standing to bring this action. Kemper basically argues that plaintiff is an atypical shareholder in that she has not taken advantage of the services provided by the Fund or Kemper. (Memorandum in Support of Kemper's Motion to Dismiss, at 4). In addition, Kemper states that the other shareholders have approved the fees charged by Kemper, and that after receiving notice of this action, they approved a fee increase. Finally, Kemper claims that plaintiff has shown no real interest or comprehension of the issues in the lawsuit. As such, Kemper contends that plaintiff cannot fairly and adequately represent the shareholders' interests in this suit.

The parties to this action alternatively refer to plaintiff's suit as a class action and a shareholders' derivative suit. Because this case was brought under §36(b) of the Act, it is not technically a derivative suit. A derivative suit allows a shareholder to claim a right that could have been, but was not, asserted by the corporation in court. Fed.R.Civ.P. 23.1; *Daily Income Fund, Inc. v. Fox*, 484 U.S. 523, 528. 104 S.Ct. 831, 834 (1984). Section 36(b) creates a right which can be enforced only by a shareholder or the Securities Exchange Commission. *Id.* at 535, 104 S.Ct. at 838. Even though such a right may be asserted on behalf of the corporation, it is not one that the corporation may assert in court. *Id.*, Consequently, the rules governing derivative suits are not applicable to §36(b) actions. The "fair and adequate" representation requirement of Rule 23.1 does not apply to plaintiff's action.

While Rule 23.1 may not be applicable, plaintiff still seeks to maintain this suit as a class action, and is therefore subject to the rules applicable to such actions. Under Rule 23, a class action may be maintained only if:

> (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and aequately [sic] protect the interests of the class.

Kemper's motion for summary judgment raises only the fourth requirement as an issue: whether plaintiff will fairly and adequately protect the interests of the class.

Adequacy of representation ensures that all class members receive the protection of their rights that due process requires. *Hansberry v. Lee*, 311 U.S. 32, 45, 61 S.Ct. 115, 119 (1940). The requirement encompasses two notions: that named plaintiff's counsel has the expertise necessary to represent the class; and that named plaintiff will pursue the claims aggressively, with no conflict between its interests and those of the class. *Secretary of Labor v. Fitzsimmons*, 805 F.2d 682, 697 (7th Cir. 1986);

Armstrong v. Chicago Park Dist., 117 F.R.D. 623, 631 (N.D. Ill. 1987).

With regard to the expertise of plaintiff's counsel, Kemper's arguments must fail. Kemper does not dispute the fact that Richard M. Meyer, plaintiff's lead counsel, has a great deal of experience in cases of this nature. Indeed, Mr. Meyer successfully argued the *Fox* case before the United States Supreme Court. 484 U.S. at 524, 104 S.Ct. at 832. Kemper is apparently far more concerned with plaintiff's own lack of knowledge in this case. Plaintiff's lack of knowledge of the case, or even her minimal involvement in the fleshing out of her claim, is not enough to warrant summary judgment in Kemper's favor. *Goldwater v. Alston & Bird*, 116 F.R.D. 342, 353 (S.D. Ill. 1987), *citing Grossman v. Waste Management, Inc.*, 100 F.R.D. 781, 792 (N.D. Ill. 1984). Thus, neither the experience of plaintiff's counsel nor the minimal knowledge of plaintiff are sufficient to prevent plaintiff's maintenance of her claim as a class action.

Thus, the other factor in judging the adequacy of plaintiff as representative of the class is whether plaintiff's interests are sufficiently commensurate with those of the other shareholders. This determination is a question of fact depending on the circumstances of each case. *Schy v. Susquehanna Corp.*, 419 F.2d 1112, 1116 (7th Cir.) *cert. denied* 400 U.S. 826 (1970). In this case, Kemper cites several material facts which have gone undisputed by plaintiff: no other shareholder has joined in this suit, instituted a claim, or inquired into plaintiff's action; the other shareholders have approved the fees charged by Kemper; after notice of plaintiff's allegations, the shareholders approved an increase in fees. Based on these

facts, it can only be said that plaintiff's interests are antagonistic to those of the other shareholders. In such a case, plaintiff cannot adequately protect those interests. *Gomez v. Illinois State Bd. of Educ.*, 117 F.R.D. 394, 402 (N.D. Ill. 1987). Plaintiff argues that the measure of adequacy of representation should not be based on the number of shareholders plaintiff represents, but on how well plaintiff can advance the interests of similarly situated shareholders. (Plaintiff's Memorandum in Opposition, at 11-12). Yet, Plaintiff points to no other similarly situated shareholders, even in the face of Kemper's contention that she stands alone. It is apparent from the record as it stands that plaintiff's concerns are not those of a class, but are a private matter. As such, plaintiff cannot maintain this suit as a class action.

For these reasons, it is recommended that defendant's motion for summary judgment on the issue of plaintiff's adequacy as class representative be granted.

Respectfully submitted,

/s/ James T. Balog
JAMES T. BALOG
United States Magistrate

DATE: APRIL 21, 1989

Any objections to this Report and Recommendation must be filed with the Clerk of court within ten (10) days of receipt of this notice. Failure to file objections within the specified time waives the right to appeal the District Court's order. Thomas v. Arn, 108 S.Ct. 466 (1985).

Copies to:

Joel J. Sprayregen
Clifford E. Yuknis
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& PROELICH
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KAMMHOLZ
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MINUTE ORDER DATED AUGUST 3, 1989
ADOPTING MAGISTRATE'S REPORT
AND RECOMMENDATION

Minute Order Form
(rev. 3/illegible)
UNITED STATES DISTRICT COURT, NORTHERN
DISTRICT OF ILLINOIS, EASTERN DIVISION

Name of Assigned Judge or Magistrate NORDBERG

Signing Judge or Mag. If Other
Than Assigned Judge/Mag. ASPEN

Case Number 85 C 4587 Date August 3, 1989

Case Title Jill Kamen v. Kemper Financial Services, Inc., et al

MOTION: [In the following box (a) indicate the party filing the motion, e.g., plaintiff, defendant, 3d-party plaintiff, and (b) state briefly the nature of the motion being presented]

DOCKET ENTRY:

(The balance of this form is reserved for notations by court staff.)

(1) ___ Judgment is entered as follows:

(2) A (Other docket entry)

The Court overrules plaintiff's objections to the Magistrate's report and recommendation of April 21, 1989. The Court adopts the Magistrate's Report and Recommendation. Accordingly, based upon the reasons set forth in the Report and Recommendation and in defendant's brief in support of its motion for summary judgment, the Court grants defendant's motion for summary judgment on the issue of plaintiff's adequacy as a class representative. This cause may proceed, if plaintiff so chooses, as a non-class action. A status hearing is set for August 15, 1989, at 2:00 p.m., before Judge Aspen. It is so ordered.

(3) ___ Filed motion of [use listing in "MOTION" box above].

Marvin E. Aspen

(4) ___ Brief in support of motion due _____

(5) ___ Answer brief to motion due _______. Reply to answer brief due _____

(6) ___ ___ Hearing
___ Ruling on _____ set for _____ at _____

(7) ___ Status hearing ___ held ___ continued to ___ set for ___ re-set for ___ at _____.

(8) ___ Pretrial conference ___ held ___ continued to ___ set for ___ re-set for _____ at _____.

(9) ___ Trial ___ set for ___ re-set for _____ at _____.

(10) ___ ___ Bench trial ___ Jury trial ___ Hearing held and continued to _____ at _____.

(11) ___ This case is dismissed ___ without ___ with prejudice and without costs ___ by agreement ___ pursuant to ___ FRCP 4(j) (failure to serve) ___ General Rule 21 (want of prosecution) ___ FRCP 41(a)(1) ___ FRCP 41(a)(2)

(12) ___ [For further detail see ___ order on the reverse of ___ order attached to the original minute order form]

___ No notices required.

___ Notices mailed by judge's staff.

___ Notified counsel by telephone.

✔ Docketing to mail notices.

___ Mail AO 450 form.

___ Copy to judge/magistrate

courtroom deputy's initials Gl

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Date/time received in central Clerk's Office

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MINUTE ORDER DATED SEPTEMBER 1, 1989
AMENDING AUGUST 3, 1989 ORDER

Minute Order Form
(rev. 3/illegible)

UNITED STATES DISTRICT COURT, NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION

Name of Assigned Judge or Magistrate NORDBERG

Signing Judge/Mag. If Other Than Assigned Judge/Mag. ASPEN

Case Number 85 C 4587 Date September 1, 1989

Case Title Jill Kamen v. Kemper Financial Services, Inc., et al

MOTION: [In the following box (a) indicate the party filing the motion, e.g., plaintiff, defendant, 3d-party plaintiff, and (b) state briefly the nature of the motion being presented]

Sent for Microfilming SEP 07 1989 Expired on Sep 8 1989

DOCKET ENTRY:

(The balance of this form is reserved for notations by court staff.)

(1) X Judgment is entered as follows:

(2) __ (Other docket entry)

Since in our August 3, 1989 order, plaintiff was adjudicated as a non-adequate representative plaintiff cannot proceed individually in this § 36(B) action. For that reason, our August 3, 1989 order is amended by deleting the following sentence: "This cause may proceed, if plaintiff so chooses, as a non-class action. "Accordingly, judgment is entered in favor of defendants. It is so ordered.

(3) __ Filed motion of [use listing in "MOTION" box above].

(4) __ Brief in support of motion due _____

(5) __ Answer brief to motion due _______. Reply to answer brief due _____

(6) __ __ Hearing
__ Ruling on _____ set for _____ at _____

(7) ✓ Status hearing ✓ held __ continued to __ set for __ re-set for __ at _____.

(8) __ Pretrial conference __ held __ continued to __ set for __ re-set for _____ at _____.

(9) __ Trial __ set for __ re-set for _____ at _____.

(10) __ __ Bench trial __ Jury trial __ Hearing held and continued to _____ at _____.

(11) __ This case is dismissed __ without __ with prejudice and without costs __ by agreement __ pursuant to __ FRCP 4(j) (failure to serve) __ General Rule 21 (want of prosecution) __ FRCP 41(a)(1) __ FRCP 41(a)(2)

(12) __ (For further detail see __ order on the reverse of __ order attached to the original minute order form)

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Date/time received in
central Clerk's Office

__ No notices required.

✓ Notices mailed by judge's staff.

__ Notified counsel by telephone.

__ Docketing to mail notices.

__ Mail AO 450 form.

__ Copy to judge/magistrate

courtroom deputy's initials Gl

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9-6-89	date mid. notices	
GL	mailing dpty. initials	

JUDGMENT DATED SEPTEMBER 1, 1989

AC 450 (Rev. 5, 85) Judgment in a Civil Case

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
Eastern Division

Jill Kamen JUDGMENT IN A CIVIL CASE

V.

Kemper Financial Services, Inc.
Cash Equivalent Fund, Inc.

CASE NUMBER: 85 C 4587

___ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

XX Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED

that since in our August 3, 1989 order, plaintiff was adjudicated as a non-adequate representative plaintiff cannot proceed individually in this § 36(B) action. For this reason, our August 3, 1989 order is amended by deleting the following sentence: "This cause may proceed, if plaintiff so chooses, as a non-class action." Accordingly, judgment is entered in favor of defendants.

9-1-89 H. STUART CUNNINGHAM
Date *Clerk*

Illegible
(By) Deputy Clerk

Supplemental Amended Complaint

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF ILLINOIS

EASTERN DIVISION

85 C 4587 – Judge Nordberg

JILL S. KAMEN,

Plaintiff,

-against-

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Defendants.

PLAINTIFF DEMANDS TRIAL BY JURY

Plaintiff, by her attorneys, alleges as follows, on information and belief, except as to the allegations in paragraph 3, which are alleged on knowledge:

1. This Court has jurisdiction of this action under the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43.

2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof.

3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund") and has been a

shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund.

4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois 60603. It is the type of investment company commonly referred to as a money market fund.

5. (a). The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have muturities [sic] not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately $4,683,000,000 in its money market portfolio and $470,000,000 in its government securities portfolio.

(b) As of November 26, 1986 the Fund's total assets consisted of $5,390,000,000 in its money market portfolio and $660,000,000 in its government securities portfolio.

6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment adviser, manager, primary administrator and underwriter for the Fund.

7 (a). During all times relevant herein, KFS has received and continues to receive a monthly fee divided

into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment management fee at the annual rate of .22 of 1% of the first $500,000,000 of the combined average daily net assets of the portfolios KFS managers, .20 of of [sic] 1% of the next $500,000,000, .175 of 1% of the next $1 billion, .16% of the next $1 billion and .15 of 1% of average daily net assets of such portfolios over $3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first $500,000,000 of average daily net assets, .30% of the next $500,000,00, [sic] .275% of the next $1 billion, .265% of the next $1 billion, and .25% of average daily net assets over $3 billion.

(b). Effective November 4, 1986, KFS caused the administration agreement with the Fund to be amended to substantially increase the fees payable by the Fund to KFS. Under the amended agreement, the Fund pays to KFS administration fees at the annual rate at .38%. This increase required a change in the expense limitation which otherwise would have been exceeded by the enormous fee burden imposed upon the Fund.

(c). The administration agreement and its amendment were purportedly adopted pursuant to Rule 12b-1 promulgated by the Securities and Exchange Commission under the Act. Under that Rule payments may be made by an investment company, such as the Fund, only if they are pursuant to a plan primarily intended to result in the sale of shares of such investment company. However, the administration agreement entered into between the Fund

and KFS and the amendment thereto encompass payments which are not primarily intended to result in the sale of Fund shares. Indeed, the payments made pursuant to the administration agreement are not based upon sales of Fund shares, but rather upon the assets previously invested in the Fund by customers of KFS affiliates and other broker-dealers to whom the payments are made. Those payments are made without regard to whether sales are being effected by such entities. They are made primarily to enrich KFS, the KFS affiliates and the broker-dealers and are designed neither to promote the sale of Fund shares nor to benefit the Fund or its shareholders.

8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid KFS nearly $20,000,000 in fees. Of this amount, $7,481,000 was paid under the investment management agreement and $11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year paid $11,602,000 to such firms. Of that amount, $2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of $33,000,000 per year. Under the amended administration agreement, firms affiliated with KFS will receive approximately $5,750,000 per year at the present size of the Fund.

9. Unlike most other investment companies, the management of the assets of the money market fund,

such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that the funds are received.

10. Despite the huge growth in the size of the Fund, the only changes in the fee structure were made on December 1, 1981 and November 4, 1986 when, in spite of the economics of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption and amendment of the administration agreement.

11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to KFS has increased enormously and disproportionately to the services rendered by it.

12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the Fund. The directors and many of the officers

and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager, and underwriter for MM and supplies to MM substantially the same services that it supplies or causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees.

13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy statement for the annual meeting of shareholders on November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first

$215,000,000 with lesser rates on additional assets." This gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund, to the damage of the Fund and its shareholders.

14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.

15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefore.

16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the foregoing, KFS has breached its fiduciary duty to the Fund.

17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the following reasons:

(a) With respect to the claims asserted under § 36(b) of the Act, no such demand is required;

(b) The board of directors of the Fund consists of ten members. Of those, three are "interested" as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called "non-interested" directors currently receive aggregate remuneration of approximately $300,000 a year for serving as directors of the Fund and of all of the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;

(c) The proxy statement referred to in paragraph 13 above stated: "The accompanying proxy is solicited by the Board of Directors of the Fund . . . ", and indeed, the directors did vote, without dissent, to distribute the proxy statement to Fund shareholders. Any suit, such as

the instant suit, brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund;

(d) Requiring the plaintiff to make a demand on the Fund or its directors to institute or prosecute this action would be futile. It would be tantamount to asking the directors to sue themselves. Moreover, were the directors to accept such an invitation and institute an action, the prosecution of the action would be in hostile hands inimical to its success;

(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;

(f) In responding to the original complaint, the Fund, both in its answer and motion to dismiss, has sought the dismissal of the complaint on substantive grounds;

(g) Under all of the circumstances present in this case, application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act.

WHEREFORE, plaintiff prays for judgment:

(1) requiring KFS to pay to the Fund its damages;

(2) awarding plaintiff the costs and expenses of this action, including reasonable attorneys' fees; and

(3) awarding plaintiff such other and further relief as the Court may deem just and proper.

Dated: Chicago, Illinois
December ___, 1986

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Attorneys for Plaintiff

PLAINTIFF'S VERIFICATION

STATE OF NEW YORK,
COUNTY OF NASSAU, ss.:

JILL S. KAMEN, being duly sworn, deposes and says that I am the plaintiff named herein, and that I have read the foregoing Amended Complaint and know the contents thereof, and that the same is true to my own knowledge except as to those matters therein stated to be alleged upon information and belief and as to those matters I believe them to be true.

____
JILL S. KAMEN

Sworn to before me this ___ day of
December, 1986

____
NOTARY PUBLIC

Statutes and Rule Involved

Section 20(a) of the Investment Company Act of 1940, as amended; 15 U.S.C. § 80a-20(a):

(a) It shall be unlawful for any person, by use of the mails or any means or instrumentality of interstate commerce or otherwise, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security of which a registered investment company is the issuer in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 36(b) of the Investment Company Act of 1940, as amended; 15 U.S.C. § 80a-35(b):

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 780 of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Section 44 of the Investment Company Act of 1940, as amended; 15 U.S.C. § 80a-43:

The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have jurisdiction of violations of this title or the rules, regulations, or orders thereunder, and, concurrently with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of, this title or the rules, regulations, or orders thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. A criminal proceeding based upon a violation of section 34, or upon a failure to file a report or other document required to be filed under this title, may be brought in the district wherein the defendant is an inhabitant or maintains his principal office or place of business. Any suit, or action to enforce any liability or duty created by, or to enjoin any violation of, this title or rules, regulations, or orders thereunder, may be brought in any such district or in the district wherein the defendant is an inhabitant or transacts business, and process in such cases may be

served in any district of which the defendant is an inhabitant or transacts business or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, 1292, and 1294 of Title 28, United States Code. No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against the Commission in any court. The Commission may intervene as a party in any action or suit to enforce any liability or duty created by, or to enjoin any noncompliance with, section 36(b) of this title at any stage of such action or suit prior to final judgment therein.

Rule 23.1

Federal Rules of Civil Procedure:

Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for

the plaintiff's failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

(2)

No. 90-516

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC. and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF IN OPPOSITION FOR RESPONDENT KEMPER FINANCIAL SERVICES, INC.

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QUESTIONS PRESENTED

1. Whether certiorari should be granted to review the court of appeals' reasoning that the futility exception to the demand requirement should not apply to shareholder derivative actions under Section 20(a) of the Investment Company Act of 1940, where (a) the facts of this case, as found by the district court and accepted by the court of appeals, showed that the plaintiff had not established futility as a matter of fact, and (b) no other court of appeals has expressly addressed the merits of the reasoning adopted by the court of appeals in this case, so that no direct, clear or settled conflict among the circuits exists at this time.

2. Whether certiorari should be granted to review the court of appeals' holding that no right to jury trial exists with respect to claims under Section 36(b) of the Investment Company Act of 1940, where that holding is consistent with the holding of every court of appeals and district court to have considered the issue.

RULE 29.1 LISTING

The following are parent corporations and subsidiaries (not wholly owned) of Kemper Financial Services, Inc.:

Parent Corporations:

Kemper Financial Companies, Inc.
Kemper Corporation
Lumbermens Mutual Casualty Company

Subsidiaries Not Wholly Owned:

Dimensional Fund Advisers, Inc.
Investors Fiduciary Trust Company
Kemper International Management, Inc.

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No. 90-516

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For The Seventh Circuit

BRIEF IN OPPOSITION FOR RESPONDENT KEMPER FINANCIAL SERVICES, INC.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is reported at 908 F.2d 1338 (1990). The opinion of the United States District Court for the Northern District of Illinois is reported at 659 F. Supp. 1153 (1987).

STATEMENT OF THE CASE

1. District Court Proceedings

Petitioner Jill S. Kamen, plaintiff below ("plaintiff"), is a shareholder in Cash Equivalent Fund, Inc. (the "Fund"), a money market mutual fund that is registered as an investment company under the Investment Company Act of

1940 ("the Act"). Respondent Kemper Financial Services, Inc. ("KFS") is the investment adviser and underwriter of the Fund.

On May 10, 1985, plaintiff filed a one-count shareholder's derivative action, asserting claims against KFS and the Fund under Sections 20(a) and 36(b) of the Act, 15 U.S.C. §§ 80a-20(a), 80a-35(b).[1] The complaint alleged that KFS had violated the proxy provisions of Section 20(a) and breached its fiduciary duty under Section 36(b) by charging excessive investment advisory fees. (Pet. App. 89a-93a.) The purported proxy violation is based on one sentence in a proxy statement to shareholders seeking continued approval of the fees charged by KFS. Plaintiff contends that the statement was misleading because it did not specify the precise structure of fees charged by KFS to Kemper Money Market Fund ("KMMF") and thereby implied that the fees charged to the Fund were lower than the fees charged to KMMF. (Pet. App. 90a-91a.) The excessive fees claim is premised largely on the assertion that the fees charged to the Fund were disproportionate to the services rendered by KFS and greater than those charged to KMMF. (Pet. App. 89a-92a.) The relief sought was disgorgement and return to the Fund of fees found to be excessive. Plaintiff demanded a trial by jury. (Pet. App. 85a.)

KFS moved to dismiss plaintiff's Section 20(a) proxy violation claim and to strike the jury demand on the Section 36(b) claim. On February 2, 1987, the district court issued a memorandum opinion and order which dismissed the Section 20(a) claim and struck the jury demand. (Pet. App. 33a-60a.)

[1] Plaintiff filed three successive complaints, the allegations of which were substantially the same. For purposes of simplicity, we will refer only to the Supplemental Amended Complaint filed on December 8, 1986. (Pet. App. 85a-95a.)

With regard to the Section 20(a) proxy violation claim, the district court held that plaintiff's generalized allegations did not satisfy the Rule 23.1 requirement that a complaint must allege the efforts made "to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Fed. R. Civ. P. 23.1. Specifically, the court found that, apart from conclusory, non-factual assertions, plaintiff's claim that a demand would be futile essentially rested on two allegations: (1) that the directors received substantial remuneration for their services, and (2) that the directors assisted KFS in soliciting the shareholders with the allegedly misleading proxy statement. Following relevant precedent, the district court concluded that Rule 23.1 would be seriously diluted and rendered ineffective if plaintiff's allegations were considered sufficient to excuse a demand. (Pet. App. 53a-54a.)

The district court also held that the plaintiff's jury demand on the Section 36(b) claim should be stricken because Section 36(b) creates an equitable cause of action. Plaintiff seeks restitution of allegedly excessive fees, a claim that is equitable in nature.

After reviewing prior judicial decisions and the legislative history of Section 36(b), the district court followed unanimous decisional law and held that "since [Section] 36(b) involves a claim for breach of fiduciary duty and limits damages to restitution of excessive fees, the action is essentially in equity and therefore not covered by the Seventh Amendment." (Pet. App. 58a.) Plaintiff argued that her claim was an action at law, which entitled her to a jury trial, simply because she requested "damages" in her complaint. The district court rejected that argument, however, stating that "[t]he semantics of Kamen's complaint cannot reign over the substance of her Section 36(b) claim, which is an action seeking restitution for excessive fees paid

to KFS." (Pet. App. 59a, n.19.) Plaintiff filed a motion for reconsideration, which was denied. (Pet. App. 61a-65a.)

Thereafter, plaintiff filed a petition for a writ of mandamus with respect to the striking of the jury demand. The Seventh Circuit denied the petition for mandamus, and this Court denied certiorari. (Pet. App. 69a, 71a.)

KFS subsequently moved for summary judgment on the Section 36(b) claim on the ground that plaintiff was not an adequate representative of the investors in the Fund. The district court dismissed the Section 36(b) claim on that ground.[2]

2. Seventh Circuit Proceedings

On appeal, plaintiff argued that the judgment should be reversed. The Seventh Circuit held that plaintiff's Section 20(a) proxy violation claim was properly dismissed for failure to make a demand. The Seventh Circuit observed that the trial court "thought [plaintiff's] allegations insufficient to excuse a demand under Rule 23.1, as do we." (Pet. App. 6a.) Without questioning the district court's factual finding, the Seventh Circuit went on to hold that the futility exception to the demand requirement should be eliminated, as a matter of federal common law. In a lengthy opinion, the court found that no Supreme Court precedent barred such a result, the desirability of which was underscored further by the fact that several other circuits had "display[ed] impatience with the futility exception." (Pet. App. 18a.) The Seventh Circuit concluded that " '[f]utility' is the only reason Kamen gives for not making a demand on her claim under [Section] 20(a). As this is an unsatisfactory reason, we agree with the district court's decision that the claim must be dismissed for failure to make a required demand." (Pet. App. 20a.)

[2] Contemporaneously with the filing of this brief in opposition, KFS has filed a conditional cross-petition in which it seeks review with respect to the sole issue on which the court of appeals ruled against it, that is, the question whether plaintiff was an adequate representative.

The Seventh Circuit also affirmed the district court's holding that plaintiff was not entitled to a jury trial on her Section 36(b) claim. The Seventh Circuit followed unanimous authority in other federal courts and adopted "both the holding and the rationale of [*In re*] *Evangelist* [,760 F.2d 27 (1st. Cir. 1985)]." (Pet. App. 30a.) The Seventh Circuit also carefully analyzed this Court's recent decision in *Teamsters, Local No. 391* v. *Terry,* 110 S. Ct. 1339 (1990), and concluded that application of the two-pronged test set forth in that case further confirmed the absence of any constitutional right to a jury trial in a Section 36(b) action.

REASONS FOR DENYING THE WRIT

I. THE SEVENTH CIRCUIT'S DECISION, DISMISSING PLAINTIFF'S DERIVATIVE ACTION UNDER SECTION 20(a) FOR FAILURE TO MAKE A DEMAND, IS CORRECT, DOES NOT CONFLICT WITH ANY PRIOR HOLDING OF THIS OR ANY OTHER COURT, AND DOES NOT WARRANT REVIEW.

A. This Case Is Not An Appropriate Vehicle For Supreme Court Review Because The Question Plaintiff Seeks To Present Is Purely Academic In The Circumstances Of This Case.

Plaintiff contends that the Seventh Circuit's decision conflicts with previous decisions of this Court and of the other courts of appeals. As we show below (*see* pages 9-13, *infra*), no such conflict exists. This case does not warrant this Court's review in any event because resolution of the purported conflict will not affect the outcome of this case. Whatever the Court might rule with respect to the Seventh Circuit's reasoning that the futility exception should be eliminated, the outcome of this case would remain unchanged because the district court properly found, on the facts of this case, that plaintiff had not established the factual elements

necessary to invoke the futility exception. The court of appeals did not question the correctness of that factual finding. Thus, the question which plaintiff seeks to present is purely academic and does not warrant further review at this time.

Plaintiff conceded below that Rule 23.1, which governs derivative actions, applies to a cause of action under Section 20(a). (Pet. App. 7a.) Rule 23.1 requires a shareholder to allege the efforts made to obtain action by the board of directors and the "reasons for the plaintiff's failure to obtain the action or for not making the effort." Fed. R. Civ. P. 23.1. Plaintiff acknowledges that she failed to make a demand on the Fund's Board of Directors. Thus, the question most immediately confronting the district court was whether plaintiff's factual allegations were sufficient to excuse her failure to make the required demand.

More specifically, the district court was required to test the sufficiency of plaintiff's assertions that demand would have been futile because (1) the directors received remuneration for their services, and (2) they approved the challenged conduct. (Pet. App. 52a-54a.) The district court found that these factual assertions were insufficient under Rule 23.1.

With regard to plaintiff's allegation concerning the directors' remuneration, the district court found that:

> The mere fact that the directors receive substantial remuneration for acting as directors does not, in and of itself, establish that they could not impartially review the merits of Kamen's excessive fee claim. If the fact that a director is paid for his services was sufficient to avoid Rule 23.1, Rule 23.1 would be rendered ineffective.

(Pet. App. 52a-53a.)

Likewise, the district court found that approval of the challenged conduct was not itself sufficient to show that a demand would be futile:

> The courts have consistently held that "mere approval of challenged conduct is insufficient to render the demand futile." *Lewis* v. *Anselmi*, 564 F. Supp. 768, 772 (S.D.N.Y. 1983); *Atkins* v. *Tony Lama Co.*, 624 F.Supp. 250, 255 (S.D. Ind. 1985); *Lewis* v. *Valley*, 476 F.Supp. 62, 64 (S.D.N.Y. 1979). *See generally Lewis* v. *Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983), and cases cited therein. As the First Circuit aptly remarked, "It does not follow . . . that a director who merely made an erroneous business judgment in connection with what was plainly a corporate act will 'refuse to do [his] duty on behalf on [sic] the corporation if [he] were asked to do so.' Indeed, to excuse demand in these circumstances — majority of the board approval of an allegedly injurious corporate act — would lead to serious dilution of Rule 23.1." *In re Kauffman Mutual Funds, Inc.*, 479 F.2d at 265 (citation omitted).

(Pet. App. 53a-54a.)

In sum, the district court found that plaintiff's two conclusory allegations, unsupported by any specific facts, were factually insufficient to excuse plaintiff's failure to make a demand on the Fund's Board of Directors before she filed suit.[3] Based on plaintiff's factual allegations, it was therefore

[3] The reasons for requiring a demand on the Board of Directors before allowing a shareholder to initiate suit apply with special force to actions under the Investment Company Act of 1940, which mandates disinterested directors. *See* 15 U.S.C. § 80a-10. In light of tne mandated independence for these decisionmakers, a court should submit an assertion of futility to more exacting scrutiny. Here, the district court specifically found that the Board was capable of considering a demand, and there is no reason to disturb that finding. (Pet. App. 56a.)

clear that plaintiff could not rely on the futility exception in this case, whatever the availability of that exception might be in the abstract. For that reason, even if the Seventh Circuit's reasoning in this case should be deemed to conflict with the holdings of other cases, that conflict would be purely academic. There is no reason for this Court to accept for review an issue that cannot conceivably affect the outcome. Even assuming that the Court could properly grant certiorari for the purpose of reviewing the reasoning of the Seventh Circuit in this case, prudential considerations argue strongly to the contrary.[4]

[4] Plaintiff's assertion (Pet. 8-10) that this Court should apply Maryland law to decide whether she has properly pled demand and futility is incorrect. Although the law of the state of incorporation may govern the substantive requirements of demand and futility when the claim for relief is based on state law, *see, e.g., Burks* v. *Lasker*, 441 U.S. 471, 475-77 (1979), and *Starrels* v. *First Nat'l Bank*, 870 F.2d 1168 (7th Cir. 1989), federal law governs the requirements of demand and futility when a claim for relief is based on federal substantive law, as in the case at bar. *See Burks*, 441 U.S. at 475-77; *see also Nussbacher* v. *Continental Ill. Nat'l Bank & Trust Co.*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976); *Thornton* v. *Evans, 692 F.2d 1064 (7th Cir. 1982).*

Moreover, the cases cited by plaintiff (Pet. 9-10 n. 3), even if controlling, would not dictate a result different from that reached by both courts below. For example, in *Parish* v. *Maryland & Va. Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512 (1968), *cert. denied*, 404 U.S. 940 (1971), which plaintiff characterizes as the leading Maryland case on point, the complaint alleged causes of action for "fraud, concealment, illegality, gross negligence, waste of corporate assets and conspiracy to conceal losses" against the directors of the corporation individually and a majority of the directors were interested. In contrast, plaintiff has not sued any director individually for any action and concedes that only three of the ten directors could be said to be interested.

B. The Seventh Circuit's Decision Does Not Directly Conflict With The Decision Of Any Other Court Of Appeals.

The petition should be denied for the additional reason that plaintiff's proffered conflict, while probably illusory, is certainly incipient at best, and does not constitute the kind of considered and settled conflict that commands the attention and scarce resources of this Court. As we have noted (*see* page 4, *supra*), the Seventh Circuit did not disagree with the district court's finding that plaintiff had simply failed to meet the factual preconditions necessary for establishing a valid excuse under the futility exception. Rather, it reached beyond that finding to assert that futility should no longer be recognized as a valid exception to the demand requirement. Other courts have shown impatience with the futility exception and have given it a narrow reading, denying its application even where the facts clearly show that the directors will not authorize the filing of suit. *See, e.g., Lewis* v. *Graves*, 701 F.2d 245 (2d Cir. 1983); *Greenspun* v. *Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) ("to be allowed, *sua sponte*, to place himself in charge without first affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional").

Nonetheless, the treatment of the issue by the court below is unique in that other courts have not heretofore considered the possibility that the futility exception no longer should be recognized. Those courts simply have assumed that the futility exception continues to exist and therefore have proceeded to apply the exception to the relevant facts, frequently finding that the exception should not be applied in the particular case. Thus, none of plaintiff's purportedly conflicting cases actually speaks to the issue raised by the Seventh Circuit; and those decisions cannot therefore be said to conflict with the decision below. What these cases show, including the decision below, is that federal common law pertaining

to the futility exception is evolving, but it is nonetheless clear that no conflict warranting review exists at this time.

Whatever the future may hold for the futility exception, this Court certainly will benefit from further consideration by the lower federal courts. As the decision below demonstrates, that process of discussion has only begun, and it would be premature at this time for this Court to terminate it. *See, e.g., McCray* v. *New York*, 461 U.S. 961, 962-63 (1983) (Stevens, J.). *See also* Stevens, *Some Thoughts on Judicial Restraint*, 66 Judicature 177, 183 (1982) ("[E]xperience with conflicting interpretations of federal [law] may help to illuminate an issue before it is finally resolved and thus may play a constructive role in the lawmaking process. The doctrine of judicial restraint teaches us that patience in the judicial resolution of conflicts may sometimes produce the most desirable result."); Brennan, *Some Thoughts on the Supreme Court's Workload*, 66 Judicature 230, 233 (1983) ("there is already in place . . . a policy of letting tolerable conflicts go unaddressed until more than two courts of appeals have considered a question").

At present, there is no conflict among the circuits because no other court of appeals has either accepted or rejected the new approach advanced by the Seventh Circuit in this case. Unless and until the decisions of the courts of appeals have developed into a pattern of settled conflict, this Court should neither preempt discussion of this issue by the lower federal courts nor devote its own scarce resources to deciding this issue. It may be that some other courts will embrace the Seventh Circuit's reasoning, while others will not. In that event, review by this Court may well become necessary. On the other hand, other courts may uniformly reject the Seventh Circuit's reasoning, and even the Seventh Circuit may then reconsider its position. In that event, this Court may never need to act. Thus, before devoting its resources to this issue, this Court should wait and see whether a direct and substantial conflict does indeed develop.

C. The Seventh Circuit's Decision Does Not Conflict With Any Prior Holding Of This Court.

To support her assertion that the decision below conflicts with prior decisions of this Court, plaintiff principally relies on three cases, the most recent of which was decided more than 80 years ago. *See Hawes* v. *Oakland*, 104 U.S. 450 (1881); *Doctor* v. *Harrington*, 196 U.S. 579 (1905); *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R.*, 213 U.S. 435 (1909). These decisions, however, do not support the conflict which plaintiff asserts to exist here.

First, the Seventh Circuit found that none of these cases is good law. (Pet. App. 18a-19a.) The issue in *Doctor* was whether a corporation should be aligned as a plaintiff or a defendant for purposes of diversity jurisdiction. As the Seventh Circuit noted, *Doctor* held that the corporation should be aligned as a defendant when the board is so hostile to the investors that demand would be futile, but that the corporation should otherwise be aligned as a plaintiff. This holding was overruled in *Smith* v. *Sperling*, 354 U.S. 91 (1957), which held that a corporation should always be aligned as a defendant for purposes of diversity, regardless of whether a demand would be futile. Thus, *Doctor* is not controlling. *Susquehanna*, which merely followed *Doctor*, also lacks precedential value.[5]

Second, each of these cases was decided prior to the adoption of Rule 23.1, the rule at issue here. *Doctor* and *Susquehanna* were decided under old Equity Rule 94 which, as the Seventh Circuit noted, "is no longer with us, having been amended many times in the course of its transformation to Rule 23.1." (Pet. App. at 19a.) *Hawes* was decided prior to

[5] Petitioner also cites *Sperling* as approving the futility exception. However, *Sperling* does not discuss the futility exception. In its recitation of the facts, the *Sperling* Court noted the district court finding that a demand on the board would have been to no avail. However, this Court did not indicate that that finding had any significance to the result. *See Sperling*, 354 U.S. at 96.

the adoption of Equity Rule 94, and actually led to the adoption of that rule. Thus, the holdings of these cases are tied to the now-defunct equity rules and cannot be assumed to govern cases under Rule 23.1.

Third, all of plaintiff's cases were decided prior to the enactment of the Investment Company Act of 1940 under which plaintiff sues. The Act specifically established procedural safeguards which require that a contract to provide investment advisory services must be approved by a majority of disinterested directors. *See* 15 U.S.C. § 80a-15(c). Furthermore, the Act established stringent standards as to when a director may be characterized as an "interested person." *See* 15 U.S.C. § 80a-2(19). With these statutory safeguards in place, demand should be required so that the directors can make the initial determination on filing suit and provide the court with a basis for determining if their action went beyond the range of reasonable business judgment if they refuse to file suit. At the time *Hawes*, *Doctor* and *Susquehanna* were decided, no such safeguards existed to protect mutual fund shareholders from interested director transactions. The holdings of these cases are not controlling for a cause of action under the 1940 Act, which was enacted after those cases were decided, which contains substantially different rules of corporate governance, and which specificially imposes standards of director independence and responsibility.

Finally, there has been a dramatic change in the decision-making procedures of corporate boards of directors, and thus the assumptions upon which this Court relied in *Hawes*, *Doctor* and *Susquehanna* are no longer valid. At the turn of the century, when those cases were decided, boards of directors normally did not decide matters relating to interested directors through committees of disinterested directors.[6] In sum, this Court has never endorsed a futility exception to the

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[6] Plaintiff's citation to two articles published between twenty and thirty years after the *Doctor* decision (*see* Pet. 7), does not undercut this argument.

demand requirement of Rule 23.1 under the procedures currently used by corporations to ensure disinterested decision-making.

The only modern authority cited by plaintiff is *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984), but that decision is fully consistent with the decision in this case. In *Fox*, the shareholder was not required to make a demand prior to proceeding under Section 36(b) because a Section 36(b) suit cannot be initiated by a corporation. Such suits may be brought only by a shareholder or by the SEC. Since the directors have no power to bring suit on behalf of the corporation, there is no purpose to be served by requiring a demand under Section 36(b). That analysis does not apply to a Section 20(a) claim, which the directors could initiate if they deemed it to have merit.

II. THE SEVENTH CIRCUIT'S HOLDING, THAT PLAINTIFF HAS NO RIGHT TO A JURY TRIAL UNDER SECTION 36(b), IS CORRECT AND DOES NOT CONFLICT WITH ANY PRIOR HOLDING OF THIS OR ANY OTHER COURT.

The Seventh Circuit's holding, that plaintiff is not entitled to a jury trial under Section 36(b), is consistent with the decisions of every court that has considered the issue. Indeed, the lower federal courts have displayed rare unanimity in ruling that no jury trial right exists under Section 36(b) because it creates only equitable rights, and this Court repeatedly has denied further review. *See Krinsk* v. *Fund Asset Management, Inc.*, 875 F.2d 404, 414 (2d Cir.), *cert. denied*, 110 S. Ct. 281 (1989); *Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.*, 835 F.2d 45, 46 (2d Cir. 1987), *cert. denied*, 485 U.S. 1034 (1988); *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 487 F. Supp. 999, 1008 (S.D.N.Y.), *mandamus denied sub nom. In re Gartenberg*, 636 F.2d 16 (2d Cir. 1980), *cert. denied*, 451 U.S. 910 (1981); *In re Evangelist*, 760 F.2d 27, 30-31 (1st Cir. 1985); *Tarlov* v. *Paine Webber Cashfund, Inc.*, 559 F. Supp. 429, 441 (D. Conn. 1983); *Jerozal* v. *Cash Reserve Management, Inc.*, [1982-1983 Transfer Binder] Fed.

Sec. L. Rep. (CCH) ¶ 99,019, at 94,827 (S.D.N.Y. Aug. 10, 1982); *Markowitz* v. *Brody*, 90 F.R.D. 542, 547-48 (S.D.N.Y. 1981); *Weissman* v. *Alliance Capital Management Corp.*, 3 Fed. R. Serv. 3d (Callaghan) 1380, 1382-84 (S.D.N.Y. Nov. 27, 1985), *mandamus denied sub. nom. In re Weissman*, 788 F.2d 5 (2d Cir. 1986).

In each of the foregoing cases, the lower federal courts exhaustively considered the language and legislative history of Section 36(b) and properly concluded that Section 36(b) actions are equitable in nature. That conclusion is correct, and no further review is warranted.

Plaintiff nonetheless suggests (Pet. 13-16) that this case warrants review on the ground that a different analysis is required under this Court's recent decision in *Teamsters, Local No. 391* v. *Terry*, 110 S. Ct. 1339 (1990). That is not the case, however, because the Seventh Circuit expressly applied the *Terry* test and concluded that the same result obtained.

In *Terry*, this Court employed a two-prong constitutional test for determining whether a cause of action involves equitable rights not subject to the Seventh Amendment jury requirement. That two-step analysis requires a court to examine (1) whether historically the action was equitable or legal in nature, and (2) whether the actual remedy sought by the plaintiff is for equitable relief or money damages. *Id.* at 1345. The Seventh Circuit expressly applied these standards to plaintiff's claim under Section 36(b), found it to be an equitable action, and affirmed the striking of the jury demand.

Although Section 36(b) did not exist when the distinction between law and equity was abolished in 1938, the Section 36(b) action is one for breach of fiduciary duty, which the *Terry* Court recognized as an eighteenth century equitable action. 110 S. Ct. at 1345. Thus, the first prong of the *Terry* test shows that Section 36(b) actions do not call for a jury trial. The second prong of the *Terry* test leads to the same conclusion. The remedy sought in a Section 36(b) action is a

return to the Fund of excessive fees — essentially an action for restitution, which is an equitable remedy. As the Seventh Circuit noted in the case at bar, "the [Section 36(b)] statute creates a fiduciary duty and enforces it with a remedy (disgorgement) common in trust cases." (Pet. App. 31a.) Thus, both prongs of this Court's two-step analysis demonstrate that plaintiff has no right to a jury trial.

Notwithstanding this clear precedent, plaintiff argues that she is entitled to a jury trial merely because the word "damages" appears in Section 36(b)(3). (Pet. 14.) As the district court pointedly observed, "[t]his argument has been rejected by every court that has considered it." (Pet. App. 58a, n. 19.) Moreover, because the legislative history repeatedly states that Section 36(b) actions are equitable, it is "impossible to conclude from the use of the word 'damages' that Congress thereby provided for a trial by jury." *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 487 F. Supp. at 1006.

In sum, plaintiff's assertion that she is entitled to a jury trial is contrary to all relevent authority and warrants no further review.

CONCLUSION

The petition for a writ of certiorari should be denied.

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Dated: October 22, 1990

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(3)

No. 90-516

In the

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

PETITIONER'S REPLY BRIEF

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No. 90-516

In the
Supreme Court of the United States
October Term, 1990

JILL S. KAMEN,

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Respondents.

PETITIONER'S REPLY BRIEF

I
ABOLITION OF THE FUTILITY EXCEPTION IS NOT ACADEMIC

Respondent KFS contends that the decision of the Court of Appeals abolishing the futility exception to the demand requirement is purely academic. The District Court held that the allegations of the complaint were insufficient to support the allegation of futility, and, according to KFS (Resp. Br., p. 6), "The Court of Appeals did not question the correctness of that factual finding." KFS myopically reads the complaint as asserting merely that the directors received remuneration for their services and that they approved the challenged conduct. (*Id.*). KFS

is incorrect, both in its reading of the complaint and in its analysis of the appellate opinion.

The complaint sets forth in considerable detail the facts underlying the allegation of futility. (92a-93a). Those facts will not be repeated here; they go well beyond mere compensation and acquiescence.

Far from accepting the finding of the District Court, the Court of Appeals, discussing the allegations of the complaint herein, implicitly found futility. It held (17a):

> . . . cases, such as our opinions in *Nussbacher* and *Thornton*, accept the board's actual or anticipated unwillingness to sue as futility adequate to excuse demand . . .

Indeed, the Court found it necessary to overrule its decision in *Nussbacher* in order to reach the result it described in no uncertain terms: abolition of the futility exception. (21a).

II

PETITIONER HAS A CONSTITUTIONAL RIGHT TO A JURY TRIAL

In *Local No. 391 v. Terry*, 110 S.Ct. 1339 (1990), this Court twice stated that the remedy sought is the more important criterion of the right to a jury trial; 110 S.Ct. at 1345 and 1348 n.8. Here petitioner seeks the legal remedy of damages. Yet respondent contends that the remedy sought is "essentially an action for restitution, which is an equitable remedy." (Resp. Br., pp. 14-15). Presumably that is because respondent measures damages by the amount of fees it received. (*Id.*, p. 2).

Damages and restitution are, of course, different remedies. Damages are designed to make good for the plaintiff's loss. Restitution is designed to take away the defendant's unjust gain. The defendant's gain may be more than the plaintiff's loss, or it may be less, or it may happen to be the same. Whichever it is, a plaintiff seeking damages must prove her loss. If she does, she recovers damages, and it makes not one whit of difference to the damage claim whether or not the defendant has made a gain or how much it has gained. In the words of 4 *Restatement, Torts 2d*, § 903, Comment (b), p. 454 (1979):

> In cases in which a tortfeasor has received from the commission of a tort against another person a benefit that constitutes unjust enrichment at the expense of the other, he is ordinarily liable to the other, at the latter's election, either for the damage done to the other's interests or for the value of the benefit received through the commission of the tort.

In short, no matter what profit, if any, the defendant may have reaped from the wrong, the damage claim remains a damage claim and is not converted into a claim for restitution.

The victim of a theft or other tort is not deprived of her damage claim at law because her loss is equivalent to the enrichment of the thief. *U.S. v. Bitter Root Development Co.*, 200 U.S. 451, 471-72 (1906); *Bruce v. Bohanon*, 436 F.2d 733, 736 (10th Cir. 1970), *cert. denied*, 403 U.S. 918 (1971); *Robine v. Ryan*, 310 F.2d 797, 798-99 (2d Cir. 1962). In each of these cases the unjust enrichment of the wrongdoing defendants was equivalent to the loss of the plaintiffs, but the actions were held to be for damages and hence to be at law, with the attendant right of jury trial. By the same

token, a damage action under Section 36(b) is at law and triable by jury, regardless of the amount of the adviser's profits.

Even if the action be characterized as restitutionary, that would not deprive petitioner of her jury right. By the seventeenth century, the remedy of restitution was available both at common law and in equity. Although this form of relief was initially only available in equity, the common law judges eventually became jealous of the expanding power of the Court of Chancery. Conscious that the common law's inflexible and formalistic requirements in both pleading and proof afforded no remedy in many meritorious cases, these judges created the action of *indebitatus assumpsit* (also known as one of the "common counts" or an action for money had and received). *Stone v. White*, 301 U.S. 532, 534 (1937); *J.W. Carter Music Co. v. Bass*, 20 F.2d 390, 393 (S.D. Tex. 1927); *Restatement of Restitution*, Introductory Note, pp. 4-10 (1937); Prosser, *Handbook of the Law of Torts* (4th Ed.), § 94 at 627-31 (1971); Fleming James, Jr., *Right to a Jury Trial in Civil Actions*, 72 Yale L.J. 655, 658-59 (1963).

It has been widely recognized that an action for money had and received is legal in form and is considered an action at law, although governed by equitable principles. *Gaines v. Miller*, 111 U.S. 395, 397-98 (1884); *Herrman v. Gleason*, 126 F.2d 936, 939-40 (6th Cir. 1942) ("This action, while legal in form, is equitable to the core"); *J.W. Carter Music Co. v. Bass, supra*, 20 F.2d at 393 ("Though an action at law, it is equitable in its nature, and is said to resemble a bill in equity, and to lie whenever a bill in equity would lie"); *Roberts v. Ely*, 113 N.Y. 128 (1889); *Byxbie v. Wood*, 24 N.Y. 607, 610-611 (1862);

Steinert v. Title Guarantee & Trust Co., 258 App. Div. 927, 16 N.Y.S.2d 749, 750 (2d Dept. 1939), *aff'd* 283 N.Y. 636 (1940); 58 C.J.S., *Money Received*, § 1 at 906-07 (1948).

Because an action for money had and received, though governed by equitable principles, is universally recognized to be one at law, a jury trial has been historically available. Ames, *The History of Assumpsit*, 2 Harv. L. Rev. 53, 57 (1888) (" . . . the right to a trial by jury was the principal reason for a creditor's preference for *Indebitatus Assumpsit*. . . . "); 3 Blackstone Commentaries at 157-58; 58 C.J.S.. *Money Received*, § 32 at 946. For examples of assumpsit cases for money had and received which were tried to a jury, *see Nash v. Towne*, 72 U.S. 689, 704 (1867); *Downey v. Hicks*, 14 How. 240, 246 (1852); *Brooks v. People's Bank*, 233 N.Y. 87, 93-94 (1922).

The fact that this action seeks recovery from a fiduciary does not change the case from one at law to one in equity. The courts have long recognized that an action for money had and received is an effective remedy for breaches of fiduciary duty. The general proposition was well stated over a century ago in *Roberts v. Ely, supra*, 113 N.Y. at 131-32:

> . . . the case falls within the familiar doctrine that money in the hands of one person, to which another is equitably entitled, may be recovered in a common-law action by the equitable owner upon an implied promise arising from the duty of the person in possession to account for and pay over the same to the person beneficially entitled. The action for money had and received to the use of another is the form in which Courts of common law enforce the equitable obligation. The scope of this remedy has been gradually

> extended to embrace many cases which were originally cognizable only in courts of equity.
>
> * * *
>
> Nor is this form of action excluded, because in a general sense there is a relation of trust between the parties arising out of the transaction. . . . the fact that money in the hands of one person is impressed with a trust in favor of another, or that the relation between them has a trust character, does not, *ispo facto*, exclude the jurisdiction of courts of law. The general rule that trusts are cognizable in equity and are enforceable only in an equitable action, is subject to many exceptions, "as, for instance, cases of bailments, and that larger class of cases where the action for money had and received for another's use is maintained *ex aequo et bono*." (Story's Eq. Jur. § 60; COMSTOCK, J., *Lawrence v. Fox*, 20 N.Y. 278.)

Corporate fiduciaries – directors and officers – are no exception to this principle. In *Gottfried v. Gottfried*, 269 App. Div. 413, 56 N.Y.S.2d 50, 59-60 (1st Dept. 1945), a derivative suit to recover, *inter alia*, monies wrongfully received by defendant-directors, the Court reviewed the cases and declared:

> [T]he holdings are clear . . . that as to a corporate fiduciary who appropriates and as to all who receive the use or benefit of such corporate money, the gist of the action is for money had and received . . . .

Accord, *Myer v. Myer*, 271 App. Div. 465, 66 N.Y.S.2d 83, 93 (1st Dept. 1946), *aff'd*, 296 NY. 979 (1947).

Damage actions for misconduct of fiduciaries are universally held to be actions at law and, therefore, triable by jury. *Ross v. Bernhard*, 396 U.S. 531, 542 (1970) (corporation's damage claim against directors for negligent breach of fiduciary duty); *Bruce v. Bohanon*, 436 F.2d 733, 736 (10th Cir. 1970), *cert. denied*, 403 U.S. 918 (1971) (damage claim for misappropriation of trade information entrusted to defendants on confidential basis). *Accord*, *National Union Elec. Corp. v. Wilson*, 434 F.2d 986, 988 (6th Cir. 1970) (corporation's damage claim against former officers and employees for breach of fiduciary duty); *Halladay v. Verschoor*, 381 F.2d 100, 109 (8th Cir. 1967) (damage claim against defendant who participated in wrongful transactions of testamentary trustee); *DePinto v. Provident Security Life Ins. Co.*, 323 F.2d 826, 836-7 (9th Cir. 1963), *cert. denied*, 376 U.S. 950 (1964) (corporation's damage claim against directors for breach of fidcuiary duty); *Robine v. Ryan*, 310 F.2d 797, 798 (2d Cir. 1962) (damage claim for defendant's wrongful appropriation of plaintiff's invention in breach of confidential relationship); *Kelly v. Dolan*, 233 F.635, 637 (3d Cir. 1916) (damage claim against corporate directors for breach of fiduciary duty).

Respondent does not contest that petitioner is entitled to a jury trial on her Section 20 claim. She is also entitled to a jury trial on her Section 36(b) claim.

CONCLUSION

The petition for a writ of certiorari should be granted.

Dated: New York, New York
November 1, 1990

Respectfully submitted,

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No. 90-516

In The

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

JOINT APPENDIX

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Petition For Certiorari Filed September 24, 1990
Certiorari Granted December 3, 1990

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Appeal from: United States District Court
civil – private – none
Filed: 9/14/89
Fee status: paid

Caption

JILL S. KAMEN,
Plaintiff-Appellant

v.

KEMPER FINANCIAL SERVICES,
INCORPORATED and CASH EQUIVALENT
FUND, INCORPORATED,
Defendants-Appellees

9/14/89	Private civil case docketed. [89-2967] [87735-1] Appearance form due on 9/25/89 for Jill S. Kamen, for Kemper Financial, for Cash Equivalent. Transcript information sheet due 9/25/89 for Richard Meyer, for Clifford Yuknis, for Joel Sprayregen. Appellant's brief due 10/24/89 for Jill S. Kamen. (elea)
11/3/89	Filed instanter motion by Appellant Jill S. Kamen to file appellant's brief. [103327-1] [89-2967] [103327-1] (ther)
11/6/89	ORDER issued GRANTING instanter motion to file appellant's brief. [103327-1] The clerk of this court is directed to file instanter the tendered copies of the appellant's brief. [89-2967] [103327-1] (gina)

11/6/89	ORDER: The following briefing schedule is hereby adopted: [89-2967] [87735-1] 2. The appellee(s) brief is due on or before 12/6/89 for Cash Equivalent, for Kemper Financial 3. The reply brief if any is due on 12/20/89 for Jill S. Kamen (gina)
11/6/89	Filed 15c appellant's brief by Jill S. Kamen. Per order [89-2967] [103630-1] (gina)
12/1/89	Filed 10c joint appendix by Appellant Jill S. Kamen, Appellee Kemper Financial, Appellee Cash Equivalent. Per order. [89-2967] [111626-1] (gina)
12/6/89	Filed motion by Appellee Cash Equivalent to adopt brief of Appellee Kemper Financial. [112103-1] [89-2967] (gina)
12/6/89	Filed 15c appellee's brief by Kemper financial, Cash Equivalent. [89-2967] [112351-1] (gina)
12/19/89	Filed 15c appellant's reply brief by Jill S. Kamen [89-2967] [116565-1] (gina)
2/21/90	ORDER: Argument set for Thursday, April 12, 1990 at 9:30 a.m. Each side limited to 20 minutes. [89-2967] [133967-1] (terr)
3/27/90	ORDER: Argument set for Friday, May 11, 1990 at 9:30 a.m. Each side limited to 20 minutes. [89-2967] [145418-1] (broo)
5/11/90	Case heard and taken under advisement by panel: Judge Initials: wjc fhe kfr Circuit Judge Walter J. Cummings, Circuit Judge Frank H. Easterbrook, Circuit Judge Kenneth F. Ripple. [89-2967] [160336-1] (broo)
5/11/90	Case argued by Joan M. Hall for Appellee Cash Equivalent, Appellee Kemper Financial, Richard Meyer for Appellant Jill S. Kamen. [89-2967] [87735-1] (broo)

7/18/90	Filed opinion of the court by Judge Easterbrook. The judgment of the district court is AFFIRMED in part, REVERSED in part, and REMANDED for further proceedings on the claim under Section 36(b). Cummings, Easterbrook, Ripple [89-2967] [87735-1] (patb)
7/18/90	ORDER: Final judgment: AFFIRMED in part, REVERSED in part and REMANDED for further proceedings on the claim under Section 36(b). Each party to bear their own costs. [89-2967] [178221-1] (patb)

UNITED STATES DISTRICT COURT DOCKET

85 C 4587

5/14/85	1	Filed 5/10/85 Complaint (JS-5)
6/5/85	5	Filed 6/4/85: Notice of motion; Motion to extend time.
6/5/85	7	Enter order dated 6/4/85: there being no objection, court grants defendant's motion for extension of time to July 2, 1985 in which to answer or otherwise plead. Status he-aring set for July 9, 1985 at 9 AM. – Nordberg, J. Mld notices 6/5/85 GV
7-3-85	8	Filed 7-2-85 notice of filing of Kemper Financial; motion to strike to dismiss PS
7-3-85	9	Filed 7-2-85 notice of filing of Kemper Financial; answer PS

7-3-85	10	Filed 7-2-85 Kemper Financial's memorandum in support of its motion to strike and dismiss PS
7-3-85	11	Filed 7-2-85 motion of defendant Cash equivalent to strike and dismiss PS
7-3-85	12	Filed 7-2-85 answer and affirmative defenses of Cash Equvilent
7/11/85	16	Enter order dated 7/2/85: Court grants defendants' motion to dismiss with respect to lack of demand on Board of Directors. Plaitniff granted leave to file amended complaint by July 29, 1985. Court grants plaintiff's oral motion for leave for Richard Meyer to appear pro hac vice. Answer brief to motion due July 29, 1985. Reply due Aug. 6, 1985. – Nordberg, J No notices required. GV
7/24/85	17	Filed 7/23/85 plaintiff's Notice of Filing and Amended Complaint and Jury Demand tcm
8/27/85	20	Filed 8/27/85 Notice of filing Appendix A to Plaintiff's Memorandum in Opposition to Defendants' Motion to Strike. tcm
9/3/85	21	Filed 8/30/85 defendant Kemper's Notice of Filing and Reply Memorandum in Support of Its Motion to Strike and Dismiss tcm
9/3/85	22	Filed 8/30/85: Reply Memorandum of Defendant Cash Equivalent Fund, Inc. in Support of Its Motion to Strike and Dismiss tcm
12/09/86	46	Minute order of 12/08/86: Plaintiff's motion to file supplemental complaint instanter is granted. Defendants are to answer or otherwise plead to supplemental complaint or or by December 23, 1986. – NORDBERG, J. Mailed ntoices 12/09/86

	48	Filed 12/08/86: Plaintiff's motion to file supplemental complaint; memorandum in support; Supplemental AMENDED COMPLAINT.
12/30/86	56	Filed 12/29/86: Notice of filing; defendant Kemper's answer to supplemental amended complaint. tcm
12/31/86	58	Filed 12/30/86: Answer of defendant Caseh Equivalent Fund to supplemental amended complaint. tcm
01/29/87	62	Filed 01/28/87: Notice of motion; Defendant Kemper Financial Service Inc.'s motion to dismiss.
	63	Filed 01/28/87: Memorandum in support of motion to dismiss.
	64	Filed 01/28/87: Exhibits to memorandum in support of motion to dismiss. etv
02/04/87	65	Minute order of 02/02/87: Judgment is entered as follows: Enter memorandum opinion and order dismissing plaintiff's section 20(a) claim for failure to make a demand on the Fund's Board of Directors. In addition, the court finds that plaintiff is not entitled to a jury trial on her section 36(b) claim and grants KFS' motion to strike her jury demand. For further detail see order attached to the original minute order form. – Nordberg, J. Mailed notices 02/04/87. (Mailed drafts 02/04/87. TPH
02/12/87	66	Filed 02/11/87: Notice of filing; Plaintiff's motion for reconsideration. tcm
02/13/87	67	Minute order of 02/10/87: Answer brief to motion for reconsideration due February 23, 1987. Filed Plaintiff's motion fo

reconsideration – Nordberg, J.
Mailed notices 02/13/87. TPH

02/24/87	68	Filed 02/23/87: Defendant's notice of filing; Response of Cash Equivalent Fund, Inc. to plaintiff's motion for reconsideration.
	69	Filed 02/23/87: Defendant Kemper Financial Services' response to plaintiff's motion for reconsideration.
03/03/87	71	Filed 03/02/87: Notice of filing; Plaintiff's memo in opposition to defendant Kemper Financial Service's motion to dismiss; attachments. GV
03/12/87	72	Minute Order of 03/11/87: The court denies plaintiff's motion for reconsideration. For further detail see order on the reverse of the original minute order form. – Nordberg, J. Mailed notices 03/12/87. etv
03/20/87	75	Filed 03/19/87: Notice of filing; Kemper Financial Services' reply memorandum in support of its motion to dismiss or for summary judgment; attachments. TPH
03/27/87	77	Filed 03/26/87: Reply memorandum of defendant Cash Equivalent Fund, Inc. in support of its motion to dismiss or for summary judgment. tcm
04/24/89	88	Entered 04/21/89: Report and Recommendation of Magistrate James T. Balog. PG
05/01/89	89	Filed 04/28/89: Plaintiff's notice of filing; Objection to the report and recommendation of Magistrate James T. Balog (attachments). ALR
05/05/89	90	Filed 05/02/89: Notice of filing; Plaintiff Jill S. Kamen's amended objection to the

report and recommendation of Magistrate James T. Balog (Exhibits). PG

05/15/89	91	Filed 05/12/89: Defendant Kemper Financial Services, Inc.'s notice of filing; Response to plaintiff's objection to the report and recommendation of Magistrate James T. Balog. DMK
06/01/89	92	Minute order of 05/31/89: Hearing held. Court grants plaintiff's motion for leave to file reply to defendant's response instanter. Nordberg, J. No notice mailed.
	93	Filed 05/31/89: Notice of motion; Motion; Reply to defendant's response. ALR
08/04/89	96	Minute order of 08/03/89: The court overrules plaintiff's objections to the Magistrate's report and recommendation of April 21, 1989. The Court adopts the Magistrate's report and reocmmendation. Accordingly, based upon the reasons set forth in the report and recommendation and in defendant's brief in support of its motion for summary judgment, the Court grants defendant's motion for summary judgment on the issue of plaintiff's adequacy as a class representative. This cause may proceed, if palintiff so chooses, as a non-class action. A status hearing is set for August 15, 1989, at 2:00 p.m. before Judge Aspen. It is so ordered. Aspen, J. Mailed notice 08/04/89. GV
09/07/89	98	Minute order of 09/01/89; Judgment is entered as follows: Since in our August 3, 1989 order, plaintiff was adjudicated as a non-adequate representative, plaintiff cannot preceed individually in this 36(b)

action. For that reason, our August 3, 1989 order is amended by deleting the following sentence: "this cause may proceed, if plaintiff so chooses, as a non-class action." Accordingly, judgment is entered in favor of defendants. It is so ordered.
Status hearing held, Aspen, J.
Notice mailed by judges staff 09/06/89.

	99	Entered judgment. Clerk.	FMP JS-6
09/14/89	100	Filed 09/13/89: Plaintiff's NOTICE OF APPEAL re. order dated 09/01/89 ($105.00 Paid.)	
10/18/89	106	Filed 10/17/89: Plaintiff's notice of filing: Parties stipulation to supplement the record; (Attachments).	GV
10/18/89	–	Certified and transmitted 10/18/89 to the 7th Circuit Court of Appeals; Supplemental record on appeal consisting of one volume of pleadings, together with transmittal letter.	

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff, – against – KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC., Defendants.	COMPLAINT PLAINTIFF DEMANDS TRIAL BY JURY JUDGE NORDBERG 85C04587

Plaintiff, by her attorneys, alleges as follows, on information and belief, except as to the allegations in paragraph 3, which are alleged on knowledge:

1. This Court has jurisdiction of this action under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43.

2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof.

3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund") and has been a shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund.

4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois

60603. It is the type of investment company commonly referred to as a money market fund.

5. The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have maturities not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately $4,683,000,000.

6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment adviser, manager, primary administrator and underwriter for the Fund.

7. During all times relevant herein, KFS has received and continues to receive a monthly fee divided into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment management fee at the annual rate of .22 of 1% of the first $500,000,000 of the combined average daily net assets of the portfolios KFS manages, .20 of 1% of the next $500,000,000, .175 of 1% of the next $1 billion, .16% of the next $1 billion and .15 of 1% of average daily net assets of such portfolios over $3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first $500,000,000 of average daily net assets,

.30% of the next $500,000,000, .275% of the next $1 billion, .265% of the next $1 billion, and .25% of average daily net assets over $3 billion.

8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid KFS nearly $20,000,000 in fees. Of this amount, $7,481,000 was paid under the investment management agreement and $11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year paid $11,602,000 to such firms. Of that amount, $2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of $20,000,000 per year.

9. Unlike most other investment companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that the funds are received.

10. Despite the huge growth in the size of the Fund, no change in the fee structure has been made since

December 1, 1981 when, in spite of the economies of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption of the administration agreement.

11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to KFS has increased enormously and disproportionately to the services rendered by it.

12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the fund. The directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager, and underwriter for MM and supplies to MM substantially the same services that it supplies or causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees.

13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy statement for the annual meeting of shareholders on November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first $215,000,000 with lesser rates on additional assets." This gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund.

14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.

15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefore.

16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the foregoing, KFS has breached its fiduciary duty to the Fund.

17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action because no such demand is required under § 36(b) of the Act.

WHEREFORE, plaintiff prays for judgment:

(1) requiring KFS to pay to the Fund its damages;

(2) awarding plaintiff the costs and expenses of this action, including reasonable attorneys' fees; and

(3) awarding plaintiff such other and further relief as the Court may deem just and proper.

Dated: New York, New York
May 1, 1985

JOEL J. SPRAYREGEN
CLIFFORD E. YUKNIS
SHEFSKY, SAITLIN & FROELICH, LTD.

By: /s/ Joel J. Sprayregen
444 North Michigan Avenue
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RICHARD M. MEYER
MILBERG WEISS BERSHAD SPECTHRIE & LERACH

By: /s/ Richard M. Meyer
One Penn Plaza
New York, New York 10119
(212) 594-5300
ATTORNEYS FOR PLAINTIFF

PLAINTIFF'S VERIFICATION

STATE OF New York)
: ss.:
COUNTY OF Nassau)

JILL S. KAMEN, being duly sworn, deposes and says that I am the plaintiff named herein, and that I have read

the foregoing Complaint and know the contents thereof, and that the same is true to my own knowledge except as to those matters therein stated to be alleged upon information and belief and as to those matters I believe them to be true.

/s/ Jill S. Kamen
JILL S. KAMEN

Sworn to before me this
4th day of May, 1985

/s/ Robert H. Garvar
NOTARY PUBLIC

ROBERT H. GARVAR
Notary Public State of New York
No. (illegible)
Qualified in Nassau County
Cert. Filed in Kings County
Commission Expires March 30, 1987

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN,	)	
Plaintiff,	)	
v.	)	No. 85 C 4587
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC.,	)	Judge Nordberg
Defendants.	)	

ANSWER AND AFFIRMATIVE DEFENSES OF
DEFENDANT CASH EQUIVALENT FUND, INC.

Defendant, CASH EQUIVALENT FUND, INC. (the "Fund"), by its attorneys, answers the Complaint of Plaintiff, JILL S. KAMEN ("Kamen"), as follows:

> "1. This Court has jurisdiction of this action under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43."

1. The Fund admits that Kamen purports to base subject matter jurisdiction on Sections 36 and 44 of the Investment Company Act of 1940 as amended (the "Act") but denies that the Complaint states a cause of action cognizable against the Fund under the aforementioned statute.

> "2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof."

2. The Fund admits that Kamen purports to base her claims on Sections 20 and 36 of the Act but denies that Kamen's Complaint states a cause of action cognizable

against the Fund under the aforementioned statute. The Fund further states that Kamen does not have standing to institute an action pursuant to Section 20 of the Act.

> "3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund") and has been a shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund."

3. The Fund admits that Kamen has been a shareholder of the Money Market Portfolio of the Fund since December 31, 1981 and that Kamen purports to bring this action on behalf of the Fund.

> "4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois 60603. It is the type of investment company commonly referred to as a money market fund."

4. The Fund admits the allegations in Paragraph 4.

> "5. The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have maturities not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately $4,683,000,000."

5. The Fund denies that the total assets of the Fund as of April 23, 1985 were approximately $4,683,000,000 and,

further answering, states that the total assets of the Fund as of April 23, 1985 were approximately $5,172,000,000. The Fund admits the remaining allegations in Paragraph 5.

> "6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment adviser, manager, primary administrator and underwriter for the Fund."

6. The Fund admits the allegations in Paragraph 6.

> "7. During all times relevant herein, KFS has received and continues to receive a monthly fee divided into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment management fee at the annual rate of .22 of 1% of the first $500,000,000 of the combined average daily net assets of the portfolios KFS manages, .20 of 1% of the next $500,000,000, .175 of 1% of the next $1 billion, .16% of the next $1 billion and .15 of 1% of average daily net assets of such portfolios over $3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first $500,000,000 of average daily net assets, .30% of the next $500,000,000, .275% of the next $1 billion, .265% of the next $1 billion, and .25% of average daily net assets over $3 billion."

7. The Fund denies that it pays KFS "a monthly fee" but admits the remaining allegations in Paragraph 7.

> "8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid

KFS nearly $20,000,000 in fees. Of this amount, $7,481,000 was paid under the investment management agreement and $11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year paid $11,602,000 to such firms. Of that amount, $2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of $20,000,000 per year."

8. The Fund admits that for the fiscal year ended July 31, 1984, it paid KFS approximately $7,481,000 in fees under the investment management agreement and approximately $11,936,000 in fees under the administration, shareholder services and distribution agreement.

The Fund further admits that during fiscal 1984, KFS paid approximately $11,602,000 of the $11,963,000 to various firms with which KFS had entered into service agreements in order to obtain services for shareholders of the Fund. The Fund further admits that of the $11,602,000, approximately $2,817,000 was paid to broker dealers affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. The Fund admits that its obligations to KFS under the agreements are based on the Fund's net assets and, therefore, fluctuate with fluctuations in the size of the Fund.

The Fund denies each and every remaining allegation in Paragraph 8.

"9. Unlike most other investment companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that the funds are received."

9. The Fund admits that assets of the Fund are invested in fixed income obligations maturing in one year or less and that in the ordinary course of operations, decisions to invest are made on the same day that the funds are received or shortly thereafter. The Fund denies each and every remaining allegation in Paragraph 9.

"10. Despite the huge growth in the size of the Fund, no change in the fee structure has been made since December 1, 1981 when, in spite of the economies of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption of the administration agreement."

10. The Fund admits that in November 1981, the administration, shareholder services and distribution agreement was adopted pursuant to and in accordance with Rule 12b-1 as adopted by the Securities and Exchange Commission under the Act; that the Fund pays fees to KFS pursuant to the terms of the administration, shareholder services and distribution agreement; and, that all but a small portion of those fees are paid to various firms that provide services to shareholders of the Fund. The Fund further admits that there has been no change in the fee structure since December 1, 1981 and that the combined

fees under the investment management agreement and under the administration, shareholder services and distribution agreement, expressed as a combined percentage of the Fund's net assets, after said date, are higher than the investment management fee alone was previously. The Fund denies each and every remaining allegation in Paragraph 10.

> "11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to KFS has increased enormously and disproportionately to the services rendered by it."

11. The Fund denies the allegations in Paragraph 11.

> "12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the fund. The directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager and underwriter for MM and supplies to MM substantially the same services that it supplies or causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees."

12. The Fund admits that KFS acts as investment manager to the Fund and other accounts and investment companies, including Kemper Money Market Fund, Inc. ("MM"), a money market fund whose investment objective of obtaining maximum current income to the extent consistent with stability of principal, is identical to that of the Fund and which invests in substantially the same types of securities as the Fund, and that the directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. Further answering, the Fund states that MM is available to investors directly through KFS, whereas the Fund is available only through certain broker dealer and other firms. KFS is the investment adviser, manager and underwriter for MM. Further answering, the Fund states that as of April 23, 1985, the total assets of the Fund were approximately $5,172,000,000 and the total assets of MM were approximately $4,736,000,000. Further answering, the Fund states that as of April 30, 1985, it had approximately 680,000 shareholders and MM had approximately 378,000 shareholders. The Fund further states that for the year ended July 31, 1984, the ratio of expenses to average net assets was .72% for the Money Market Portfolio of the Fund and .53% for MM.

The Fund denies each and every remaining allegation in Paragraph 12.

> "13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy statement for the annual meeting of shareholders on November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first $215,000,000 with lesser rates on additional assets." This gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund."

13. Concurrent with filing its Answer herein, the Fund has moved to strike and dismiss those portions of

Kamen's Complaint that purport to state a claim pursuant to Section 20 of the Act. The allegations in Paragraph 13 relate only to Kamen's claim brought pursuant to Section 20 and, accordingly, the Fund will answer these allegations, if necessary, after the disposition of said motion.

> "14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates."

14. The Fund denies the allegations in Paragraph 14.

> "15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefore."

15. The Fund denies the allegations in Paragraph 15.

> "16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the

> foregoing, KFS has breached its fiduciary duty to the Fund."

16. The first sentence of Paragraph 16 is a legal conclusion which is not directed against the Fund and which the Fund is not required to answer. The Fund denies the allegations in the second sentence of Paragraph 16.

> "17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action because no such demand is required under § 36(b) of the Act."

17. The Fund admits that no demand has been made by Kamen upon the Fund or its directors. The remaining allegation in Paragraph 17 is a legal conclusion which the Fund is not required to answer.

WHEREFORE, Defendant, CASH EQUIVALENT FUND, INC. prays that this Court enter judgment in its favor dismissing with prejudice all claims of Plaintiff, JILL S. KAMEN, and awarding said Defendant its costs including attorneys' fees in defending this action.

FIRST AFFIRMATIVE DEFENSE

The Complaint fails to state a claim upon which relief can be granted.

SECOND AFFIRMATIVE DEFENSE

Kamen has failed to state a cause of action on behalf of the Fund under § 20 (15 U.S.C. § 80a-20) because she did not make a demand on the Fund or its directors to initiate suit.

THIRD AFFIRMATIVE DEFENSE

Kamen has failed to state a cause of action under § 20 (15 U.S.C. § 80a-20) because no private cause of action exists under § 20 for the allegations in the Complaint.

CASH EQUIVALENT FUND, INC.

By /s/ Arthur J. McGivern
One Of Its Attorneys

Charles F. Custer
Arthur J. McGivern
Gwenda M. Burkhardt

Of Counsel:

VEDDER, PRICE, KAUFMAN & KAMMHOLZ
115 South LaSalle Street
Chicago, Illinois 60603
312/781-2200

Dated: July 2, 1985

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	
v.	)	No. 85 C 4587
KEMPER FINANCIAL SERVICES, INC. and CASH EQUIVALENT FUND, INC., Defendants.	)	Judge Nordberg

ANSWER OF DEFENDANT
KEMPER FINANCIAL SERVICES, INC.

Defendant Kemper Financial Services, Inc. ("KFS"), by its attorneys, Jenner & Block, for its answer to plaintiff's complaint, the allegations of which appear below in brackets, states as follows:

[1. This Court has jurisdiction of this action under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43.]

ANSWER: Paragraph 1 is a legal conclusion which KFS is not required to answer.

[2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof.]

ANSWER: KFS denies the allegations in Paragraph 2.

[3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund") and has been a shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund.]

ANSWER: KFS admits that plaintiff has been a shareholder of the Money Market Portfolio of the Fund since December 31, 1981. KFS denies that plaintiff is authorized to bring this action on behalf of the Fund and, further answering, states that plaintiff has failed to make a demand on the Board of Directors of the Fund to file suit.

[4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois 60603. It is the type of investment company commonly referred to as a money market fund.]

ANSWER: KFS admits the allegations in Paragraph 4.

[5. The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have maturities not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately $4,683,000,000.]

ANSWER: KFS denies that the total assets of the Fund as of April 23, 1985 were approximately $4,683,000,000 and, further answering, states that the total assets of the Fund as of April 23, 1985 were approximately $5,172,000,000. KFS admits the remaining allegations in Paragraph 5.

[6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment

adviser, manager, primary administrator and underwriter for the Fund.]

ANSWER: KFS admits the allegations in Paragraph 6.

[7. During all times relevant herein, KFS has received and continues to receive a monthly fee divided into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment management fee at the annual rate of .22 of 1% of the first $500,000,000 of the combined average daily net assets of the portfolios KFS manages, .20 of 1% of the next $500,000,000, .175 of 1% of the next $1 billion, .16% of the next $1 billion and .15 of 1% of average daily net assets of such portfolios over $3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first $500,000,000 of average daily net assets, .30% of the next $500,000,000, .275% of the next $1 billion, .265% of the next $1 billion, and .25% of average daily net assets over $3 billion.]

ANSWER: KFS denies that it receives "a monthly fee," but, further answering, admits that it receives two separate fees, each on a monthly basis. KFS admits the remaining allegations in Paragraph 7.

[8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid KFS nearly $20,000,000 in fees. Of this amount, $7,481,000 was paid under the investment management agreement and $11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year paid $11,602,000 to such firms. Of that amount, $2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's

obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of $20,000,000 per year.]

ANSWER: KFS admits that for the fiscal year ended July 31, 1984, it received approximately $7,481,000 in fees under the investment management agreement and approximately $11,936,000 in fees under the administration, shareholder services and distribution agreement. KFS further admits that during fiscal 1984, KFS paid approximately $11,602,000 of the $11,936,000 to various firms with which KFS had entered into service agreements in order to obtain services for shareholders of the Fund. KFS further admits that of the $11,602,000, approximately $2,817,000 was paid to broker dealers affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. KFS admits that since the fee is calculated as a percentage of Fund assets, the Fund's obligations to KFS under the agreements increase with increases in the size of the Fund.

KFS denies each and every remaining allegation in Paragraph 8.

[9. Unlike most other companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the Fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that the funds are received.]

ANSWER: KFS admits that assets of the Fund are invested in fixed income obligations maturing in one year

or less and that, in the ordinary course of operations, decisions to purchase are made on the same day that the funds are received or shortly thereafter.

KFS denies each and every remaining allegation in Paragraph 9.

[10. Despite the huge growth in the size of the Fund, no change in the fee structure has been made since December 1, 1981 when, in spite of the economies of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption of the administration agreement.]

ANSWER: KFS admits that there has been no change in the fee structure since December 1, 1981. KFS further admits that in November 1981, the administration, shareholder services and distribution agreement was adopted pursuant to and in accordance with Rule 12b-1 as adopted by the Securities and Exchange Commission under the Act; that the Fund pays fees to KFS pursuant to the terms of the administration, shareholder services and distribution agreement; and, that all but a small portion of those fees are paid to various firms that provide services to the shareholders of the Fund. KFS further admits that the combined investment management and administration, shareholder services and distribution fee structure, expressed as a combined percentage of the Fund's net assets, is higher after December 1, 1981, than the investment management fee alone was prior to that date.

KFS denies each and every remaining allegation in paragraph 10.

[11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to

KFS has increased enormously and disproportionately to the services rendered by it.]

ANSWER: KFS denies the allegations in Paragraph 11.

[12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the fund. The directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager, and underwriter for MM and supplies to MM substantially the same services that it supplies or causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result, the Fund's yield for the year ended September 30, 1984 was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees.]

ANSWER: KFS admits that it acts as investment manager to the Fund and other accounts and investment companies, including Kemper Money Market Fund, Inc. ("MM"), a money market fund whose objective of obtaining maximum current income to the extent consistent with stability of principal, is identical to that of the Fund

and which invests in substantially the same types of securities as the Fund. KFS further admits that the directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund and that KFS is the investment adviser, manager and underwriter for MM. KFS further admits that for the year ended July 31, 1984, the ratio of expenses to average net assets was .72% for the Money Market Portfolio and .65% for the Government Securities Portfolio of the Fund and .53% for MM.

Further answering, KFS states that as of April 23, 1985, the total assets of the Fund were approximately $5,172,000,000 and the total assets of MM were approximately $4,736,000,000 and that as of April 30, 1985, the Fund had approximately 687,000 shareholders and MM had approximately 374,000 shareholders.

KFS denies each and every remaining allegation in Paragraph 12.

[13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy statement for the annual meeting of shareholders on November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first $215,000,000 with lesser rates on additional assets." This

gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund.]

ANSWER: KFS admits that pursuant to a proxy statement dated September 12, 1984, shareholders of the Fund were asked to approve the continuance of the investment management agreement between the Fund and KFS. KFS further admits that the proxy statement included the following language. "No consideration has been given to what action would be taken if shareholder approval of the agreement is not received." KFS admits that the proxy statement included information regarding rates of fees paid to KFS by other investment companies including MM. KFS further admits that the shareholders approved the continuance of the investment management agreement.

KFS denies each and every remaining allegation in paragraph 13.

[14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts,

and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.]

ANSWER: KFS denies the allegations in Paragraph 14.

[15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefore.]

ANSWER: KFS denies the allegations in Paragraph 15.

[16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the foregoing, KFS has breached its fiduciary duty to the Fund.]

ANSWER: The first sentence of Paragraph 16 is a legal conclusion which KFS is not required to answer. KFS denies the allegations in the second sentence of Paragraph 16.

[17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action because no such demand is required under § 36(b) of the Act.]

ANSWER: KFS admits that no demand has been made by the plaintiff upon the Fund or its directors. The remaining allegation in Paragraph 17 is a legal conclusion which KFS is not required to answer.

WHEREFORE, defendant KFS denies that the plaintiff is entitled to judgment against KFS in any amount and prays that the complaint be dismissed with prejudice, and that KFS be awarded its costs and attorneys' fees.

FIRST AFFIRMATIVE DEFENSE

The complaint fails to state a claim upon which relief can be granted.

SECOND AFFIRMATIVE DEFENSE

Plaintiff has failed to state a cause of action on behalf of the Fund under § 20 (15 U.S.C. § 80a-20) because she did not make a demand on the Fund or its directors to initiate suit.

THIRD AFFIRMATIVE DEFENSE

Plaintiff has failed to state a cause of action under § 20 (15 U.S.C. § 80a-20) because no private cause of action exists under § 20 for the allegations in the complaint.

KEMPER FINANCIAL
SERVICES, INC.

By Joan M. Hall
One of its Attorneys

Joan M. Hall
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Dated: July 2, 1985

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	
v.	)	No. 85 C 4587 Judge Nordberg
KEMPER FINANCIAL SERVICES, INC. and CASH EQUIVALENT FUND, INC., Defendants.	)	

DEFENDANT KEMPER FINANCIAL SERVICES, INC.'s ANSWER TO SUPPLEMENTAL AMENDED COMPLAINT

Defendant Kemper Financial Services, Inc. ("KFS"), by its attorneys, for its answer to plaintiff's supplemental amended complaint, the allegations of which appear below in brackets, states as follows:

[1. This Court has jurisdiction of this action under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43.]

ANSWER: The allegation contained in Paragraph 1 is a legal conclusion which KFS is not required to answer.

[2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof.]

ANSWER: KFS denies the allegations in Paragraph 2.

[3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund") and has been a shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund.]

ANSWER: KFS admits that plaintiff is a current shareholder in defendant Cash Equivalent Fund. KFS denies that plaintiff is authorized to bring this action on behalf of the Fund, and further answering states that the plaintiff is not an appropriate representative for the shareholders of the Fund and has failed to make a demand on the Board of Directors of the Fund to file suit.

[4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois 60603. It is the type of investment company commonly referred to as a money market fund.]

ANSWER: KFS admits the allegations in Paragraph 4.

[5. (a). The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have maturities not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately $4,683,000,000 in its money market portfolio and $470,000,000 in its government securities portfolio.

(b) As of November 26, 1986 the Fund's total assets consisted of $5,390,000,000 in its money market portfolio and $660,000,000 in its government securities portfolio.]

ANSWER: KFS denies that the total assets of the Fund, as of April 23, 1985, were approximately $4,683,000,000 in its Money Market Portfolio and

$470,000,000 in its Government Securities Portfolio and, further answering, states that the total net assets of the Fund, as of April 23, 1985, were approximately $4,700,000,000 in its Money Market Portfolio and $472,000,000 in its Government Securities Portfolio. KFS denies that, as of November 26, 1986, the Fund's assets in its Government Securities Portfolio were $660,000,000 and, further answering, states that, as of November 26, 1986, the total net assets in the Government Securities Portfolio of the Fund were approximately $666,000,000.

KFS admits the remaining allegations in Paragraph 5.

[6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment adviser, manager, primary administrator and underwriter for the Fund.]

ANSWER: KFS admits the allegations in Paragraph 6.

[7. (a). During all times relevant herein, KFS has received and continues to receive a monthly fee divided into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment fee at the annual rate of .22 of 1% of the first $500,000,000 of the combined average daily net assets of the portfolios KFS manages, .20 of 1% of the next $500,000,000, .175 of 1% of the next $1 billion, .16% of the next $1 billion and .15 of 1% of average daily net assets of such portfolios over $3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first $500,000,000 of average daily net assets, .30% of the next $500,000,000, .275% of the next $1 billion, .265% of the next $1 billion, and .25% of average daily net assets over $3 billion.

(b). Effective November 4, 1986, KFS caused the administration agreement with the Fund to be amended to substantially increase the fees payable by the Fund to KFS. Under the amended agreement, the Fund pays to KFS administration fees at the annual rate of .38%. This increase required a change in the expense limitation which otherwise would have been exceeded by the enormous fee burden imposed upon the Fund.

(c). The administration agreement and its amendment were purportedly adopted pursuant to Rule 12b-1 promulgated by the Securities and Exchange Commission under the Act. Under that Rule, payments may be made by an investment company, such as the Fund, only if they are pursuant to a plan primarily intended to result in the sale of shares of such investment company. However, the administration agreement entered into between the Fund and KFS and the amendment thereto encompass payments which are not primarily intended to result in the sale of Fund shares. Indeed, the payments made pursuant to the administration agreement are not based upon sales of Fund shares, but rather upon the assets previously invested in the Fund by customers of KFS affiliates and other broker-dealers to whom the payments are made. Those payments are made without regard to whether sales are being effected by such entities. They are made primarily to enrich KFS, the KFS affiliates and the broker-dealers and are designed neither to promote the sale of Fund shares not to benefit the Fund or its shareholders.]

ANSWER: With respect to subparagraph (a), KFS denies that it received "a monthly fee," but further answering admits that it receives two separate fees, each on a monthly basis. KFS admits the remaining allegations in subparagraph 7(a).

With respect to subparagraph (b), KFS admits that on November 4, 1986, the shareholders of the Fund approved an increase in the fees payable by the Fund to

KFS under the administration, shareholder services and distribution agreement and that, pursuant to this amendment, the Fund pays these fees to KFS at an annual rate of .38%. KFS denies that this increase was effective November 4, 1986 and, further answering, states that it was effective on December 1, 1986. KFS further admits that the shareholders also approved an amendment to the expense limitation which otherwise would have been exceeded as a result of the newly approved fees. KFS denies the remaining allegations in subparagraph 7(b).

With respect to subparagraph (c), KFS admits that the administration, shareholder services and distribution agreement and its amendment were adopted pursuant to Rule 12b-1 promulgated by the Securities and Exchange Commission. KFS further admits that payments made under the administration, shareholder services and distribution agreement are based upon assets invested in the Fund. KFS denies the remaining allegations in subparagraph 7(c).

[8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid KFS nearly $20,000,000 in fees. Of this amount, $7,481,000 was paid under the investment management agreement and $11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year, paid $11,602,000 to such firms. Of that amount, $2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of $33,000,000 per year. Under the amended administration agreement, firms affiliated with KFS will

receive approximately $5,750,000 per year at the present size of the Fund.]

ANSWER: KFS admits that for the fiscal year ended July 31, 1984, it received approximately $7,481,000 in fees under the investment management agreement and approximately $11,936,000 in fees under the administration, shareholder services and distribution agreement. KFS further admits that, during fiscal 1984, KFS paid approximately $11,602,000 of the $11,936,000 to various firms with which KFS had entered into service agreements in order to obtain services for shareholders of the Fund. KFS further admits that of the $11,602,000 approximately $2,817,000 was paid to broker-dealers affiliated with Kemper Corporation, of which KFS is a wholly owned indirect subsidiary. KFS admits that, since the fee is calculated as a percentage of Fund assets, the Fund's obligations to KFS under the agreements increase with increases in the size of the Fund. KFS admits that under the amended administration, shareholder services and distribution agreement, firms affiliated with Kemper Corporation will receive approximately $5,618,000 per year at the present size of the Fund.

KFS denies each and every remaining allegation in Paragraph 8.

[9. Unlike most other investment companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations,

decisions to purchase are made on the same day that the funds are received.]

ANSWER: KFS admits that the assets of the Fund are invested in fixed income obligations maturing in one year or less and that, in the ordinary course of operations, decisions to purchase are made on the same day that the funds are received or shortly thereafter.

KFS denies each and every remaining allegation in Paragraph 9.

[10. Despite the huge growth in the size of the Fund, the only changes in the fee structure were made on December 1, 1981 and November 4, 1986 when, in spite of the economies of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption and amendment of the administration agreement.]

ANSWER: KFS admits that changes in the fee structure occurred on December 1, 1981 and November 4, 1986 (effective December 1, 1986). KFS further admits that in November 1981, the administration, shareholder services and distribution agreement was adopted pursuant to and in accordance with Rule 12b-1 as adopted by the Securities and Exchange Commission under the Act; that the Fund pays fees to KFS pursuant to the terms of the administration, shareholder services and distribution agreement; and that all but a small portion of those fees are paid to various firms that provide services to the shareholders to the Fund. KFS further admits that the combined fee structure for the investment management agreement and for the administration, shareholder services and distribution agreement, expressed as a combined percentage of the Fund's net assets, was higher after December 1, 1981, than the investment management

fee alone was prior to that date. KFS further admits that the combined fee structure is higher after the November 4, 1986 amendment (effective December 1, 1986), than it was prior to that amendment, which was approved by shareholder vote.

KFS denies each and every remaining allegation in Paragraph 10.

[11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to KFS has increased enormously and disproportionately to the services rendered by it.]

ANSWER: KFS denies the allegations contained in Paragraph 11.

[12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the Fund. The directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager, and underwriter for MM and supplies to MM substantially the same services that it supplies or causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result,

the Fund's yield for the year ended September 30, 1984, was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees.]

ANSWER: KFS admits that it acts as investment manager to the Fund and other accounts and investment companies, including Kemper Money Market Fund ("MM"), a money market fund whose objective is obtaining maximum current income to the extent consistent with stability of principal. KFS admits that MM's investment objective is identical to that of the Fund and that MM invests in substantially the same types of securities as the Fund. KFS further admits that the directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund and that KFS is the investment adviser, manager and underwriter for MM. KFS further admits that, for the year ended July 31, 1984, the ratio of expenses to average net assets was .72% for the Money Market Portfolio and .65% for the Government Securities Portfolio of the Fund and .53% for MM.

Further answering, KFS states that, as of April 23, 1985, the total assets of the Fund were approximately $5,172,000,000 and the total assets of MM were approximately $4,736,000,000, and that, as of May 31, 1985, the Fund had approximately 687,000 shareholders and MM had approximately 374,000 shareholders.

KFS denies each and every remaining allegation of Paragraph 12.

[13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy

statement for the annual meeting of shareholders on November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first $215,000,000 with lesser rates on additional assets." This gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund, to the damage of the Fund and its shareholders.]

ANSWER: KFS admits that, pursuant to a proxy statement dated September 12, 1984, shareholders of the Fund were asked to approve the continuance of the investment management agreement between the Fund and KFS. KFS further admits that the proxy statement included the following language: "No consideration has been given to what action would be taken if shareholder approval of the agreement is not received." KFS admits that the proxy statement included information regarding

rates and fees paid to KFS by other investment companies, including MM. KFS further admits that the shareholders approved the continuance of the investment management agreement.

KFS denies each and every remaining allegation in Paragraph 13.

[14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this complaint. Other advisers performed and have performed similar or superior services for lesser rates.]

ANSWER: KFS denies the allegations in Paragraph 14.

[15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefor.]

ANSWER: KFS denies the allegations in Paragraph 15.

[16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from the Fund. By virtue of the foregoing, KFS has breached its fiduciary duty to the Fund.]

ANSWER: The first sentence of Paragraph 16 is a legal conclusion which KFS is not required to answer. KFS denies the allegations in the second sentence of Paragraph 16.

[17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the following reasons:

(a) With respect to the claims asserted under § 38(b) of the Act, no such demand is required;

(b) The board of directors of the Fund consists of ten members. Of those, three are "interested" as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called "non-interested" directors currently receive aggregate remuneration of approximately $300,000 a year for serving as directors of the Fund and of all the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;

(c) The proxy statement referred to in paragraph 13 above stated: "The accompanying proxy is solicited by the Board of Directors of the Fund . . . ", and indeed, the directors did vote, without dissent, to distribute the proxy statement to Fund shareholders. Any suit, such as the instant suit, brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all the directors of the Fund;

(d) Requiring the plaintiff to make a demand on the Fund or its directors to institute or prosecute this action would be futile. It would be tantamount to asking the directors to sue themselves. Moreover, were the directors to accept such an invitation and institute an action, the prosecution of the action would be in hostile hands inimical to its success;

(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;

(f) In responding to the original complaint, the Fund, both in its answer and motion to dismiss, has sought the dismissal of the complaint on substantive grounds;

(g) Under all of the circumstances present in this case, application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act.]

ANSWER: KFS admits that no demand has been made by the plaintiff upon the Fund or its directors.

KFS denies that the Fund and its directors are under the control of KFS and denies that there is no demand requirement.

The remaining allegations in Paragraph 17 are either legal conclusions or are directed toward parties other than KFS, and therefore KFS is not required to provide any answer.

WHEREFORE, defendant KFS denies that the plaintiff is entitled to judgment against KFS in any amount and prays that the supplemental amended complaint be dismissed with prejudice, and that KFS be awarded its costs and attorneys' fees. KFS further denies that plaintiff is entitled to a trial by jury.

FIRST AFFIRMATIVE DEFENSE

The supplemental amended complaint fails to state a claim upon which relief can be granted.

SECOND AFFIRMATIVE DEFENSE

Plaintiff has failed to state a cause of action on behalf of the Fund under Section 20 (15 U.S.C. § 80a-20) because she did not make a demand on the Fund or its directors to initiate suit.

THIRD AFFIRMATIVE DEFENSE

Plaintiff has failed to state a cause of action under Section 20 (15 U.S.C.. § 80a-20) because no private cause of action exists under Section 20 for the allegations in the complaint.

FOURTH AFFIRMATIVE DEFENSE

Plaintiff is not a fair and adequate representative of the shareholders of the Fund and therefore cannot maintain this action.

KEMPER FINANCIAL
SERVICES, INC.

By Joel T. Pelz
One of Its Attorneys

Joan M. Hall
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(312) 222-9350

DATED: December 29, 1986

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	
v.	)	No. 85 C 4587
	)	Judge Nordberg
KEMPER FINANCIAL SERVICES, INC. and CASH EQUIVALENT FUND, Defendants.	)	

ANSWER OF DEFENDANT, CASH EQUIVALENT FUND TO SUPPLEMENTAL AMENDED COMPLAINT

Defendant CASH EQUIVALENT FUND ("the Fund"), by its attorneys, for its answer to plaintiff's supplemental amended complaint, states as follows:

1. This Court has jurisdiction of this action under the Investment Company Act of 1940 as amended, 15 U.S.C. § 80a-1 et seq. (the "Act"), and in particular § 36 and § 44 thereof, 15 U.S.C. § 80a-35 and § 80a-43.

ANSWER: 1. The allegation contained in Paragraph 1 is a legal conclusion which the Fund is not required to answer.

2. The cause of action arises under the Act and in particular under § 20 and § 36 thereof.

ANSWER: 2. The Fund denies the allegations of Paragraph 2.

3. Plaintiff is a shareholder of defendant Cash Equivalent Fund, (the "Fund") and has been a shareholder of the Fund at all times relevant herein. Plaintiff brings this action on behalf of the Fund.

ANSWER: 3. The Fund admits that plaintiff is a current shareholder in defendant Cash Equivalent Fund, a Massachusetts business trust. The Fund denies that plaintiff is authorized to bring this action on behalf of the Fund, and further answering, states that the plaintiff is not an appropriate representative of the shareholders of the Fund and has failed to make a demand on the Fund's Board of Trustees to file this suit.

4. The Fund is a diversified open-end investment company registered with the Securities and Exchange Commission under the Act. Its principal place of business is located at 120 South LaSalle Street, Chicago, Illinois 60603. It is the type of investment company commonly referred to as a money market fund.

ANSWER: 4. The Fund admits the allegations of Paragraph 4.

5. (a) The Fund's investment objective is to seek the maximum current income consistent with stability of capital. The Fund invests in a range of short-term money market instruments which have maturities not exceeding one year. These instruments include obligations of the United States Government and its agencies and instrumentalities, certificates of deposit, bankers acceptances, fixed time deposits, commercial paper, and repurchase agreements. Although the Fund did not commence operations until March 16, 1979, its total assets as of April 23, 1985 were approximately $4,683,000,000 in its money market portfolio and $470,000,000 in its government securities portfolio.

(b) As of November 26, 1986 the Fund's total assets consisted of $5,390,000,000 in its money market portfolio and $660,000,000 in its government securities portfolio.

ANSWER: 5. The Fund denies that the total assets of the Fund, as of April 23, 1985, were approximately

$4,683,000,000 in its Money Market Portfolio and $470,000,000 in its Government Securities Portfolio and, further answering, states that the total net assets of the Fund, as of April 23, 1985, were approximately $4,700,000,000 in its Money Market Portfolio and $472,000,000 in its Government Securities Portfolio. The Fund denies that, as of November 26, 1986, the Fund's assets in its Government Securities Portfolio were $660,000,000 and, further answering, states that, as of November 26, 1986, the total net assets in the Government Securities Portfolio of the Fund were approximately $666,000,000. The Fund admits the remaining allegations of Paragraph 5.

6. At all times relevant herein, defendant Kemper Financial Services, Inc. ("KFS") has acted as investment adviser, manager, primary administrator and underwriter for the Fund.

ANSWER: 6. The Fund admits the allegations of Paragraph 6.

7. (a) During all times relevant herein, KFS has received and continues to receive a monthly fee divided into two parts and paid under two separate agreements. Under an investment management agreement, the Fund pays KFS an investment management fee at the annual rate of .22 of 1% of the first $500,000,000 of the combined average daily net assets of the portfolios KFS manages, .20 of 1% of the next $500,000,000, .175 of 1% of the next $1 billion, .16% of the next $1 billion and .15 of 1% of average daily net assets of such portfolios over $3 billion. Under an administration, shareholder services and distribution agreement ("administration agreement") the Fund pays KFS an annual fee, payable monthly, on a basis of .33% of the first $500,000,000 of average daily net assets, .30% of the next $500,000,000, .275% of the next $1 billion,

.265% of the next $1 billion, and .25% of average daily net assets over $3 billion.

(b) Effective November 4, 1986, KFS caused the administration agreement with the Fund to be amended to substantially increase the fees payable by the Fund to KFS. Under the amended agreement, the Fund pays to KFS administration fees at the annual rate of .38%. This increase required a change in the expense limitation which otherwise would have been exceeded by the enormous fee burden imposed upon the Fund.

(c) The administration agreement and its amendment were purportedly adopted pursuant to Rle 12b-1 promulgated by the Securities and Exchange Commission under the Act. Under that Rule, payments may be made by an investment company, such as the Fund, only if they are pursuant to a plan primarily intended to result in the sale of shares of such investment company. However, the administration agreement entered into between the Fund and KFS and the amendment thereto encompass payments which are not primarily intended to result in the sale of Fund shares. Indeed, the payments made pursuant to the administration agreement are not based upon sales of Fund shares, but rather upon the assets previously invested in the Fund by customers of KFS affiliates and other broker-dealers to whom the payments are made. Those payments are made without regard to whether sales are being effected by such entities. They are made primarily to enrich KFS, the KFS affiliates and the broker-dealers and are designed neither to promote the sale of Fund shares nor to benefit the Fund or its shareholders.

ANSWER: 7. With respect to subparagraph 7(a), the Fund denies that it paid KFS "a monthly fee," but, further answering, states that it pays KFS two separate fees, each on a monthly basis. The Fund admits the remaining allegations of subparagraph 7(a).

With respect to subparagraph 7(b), the Fund admits that on November 4, 1986, the shareholders of the Fund

approved an increase in the fees payable by the Fund to KFS under the administration, shareholder services and distribution agreement and that, pursuant to this amendment, the Fund pays these fees to KFS at an annual rate of .38%. The Fund denies that this increase was effective November 4, 1986 and, further answering, states rather that it became effective on December 1, 1986. The Fund further admits that its shareholders also approved an amendment to the expense limitation which otherwise would have been exceeded as a result of the newly approved fees. The Fund denies the remaining allegations of subparagraph 7(b).

With respect to subparagraph 7(c), the Fund admits that the administration agreement and its amendment were adopted pursuant to Rule 12b-1 promulgated by the Securities and Exchange Commission. The Fund further admits that payments made under the administration agreement are based upon assets invested in the Fund. The Fund denies the remaining allegations of subparagraph 7(c).

8. Because of the tremendous growth in the size of the Fund, the fees paid and payable to KFS have increased enormously. Thus, for the fiscal year ended July 31, 1984, the Fund paid KFS nearly $20,000,000 in fees. Of this amount, $7,481,000 was paid under the investment management agreement and $11,936,000 was paid under the administration agreement. KFS has entered into related services agreements with various firms and, during the 1984 fiscal year, paid $11,602,000 to such firms. Of that amount, $2,817,000 was paid to broker-dealer firms affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. At the present time, the Fund's obligations to KFS under the agreements have increased with the size of the Fund and are running at a rate in excess of $33,000,000 per year. Under the amended administration agreement, firms affiliated with KFS will receive approximately $5,750,000 per year at the present size of the Fund.

ANSWER: 8. The Fund admits that for the fiscal year ended July 31, 1984, it paid KFS approximately $7,481,000 in fees under the investment management agreement and approximately $11,936,000 in fees under the administration, shareholder services and distribution agreement. The Fund further admits that, during fiscal 1984, KFS paid approximately $11,602,000 of the $11,936,000 to various firms with which KFS had entered into service agreements in order to obtain services for shareholders of the Fund. The Fund further admits that of the $11,602,000, approximately $2,817,000 was paid to broker-dealers affiliated with Kemper Corporation, of which KFS is a wholly owned subsidiary. The Fund admits that, since the fee is calculated as a percentage of Fund assets, the Fund's obligations to KFS under the agreements increase with increases in the size of the Fund. The Fund admits that under the amended administration, shareholder services and distribution agreement, firms affiliated with Kemper Corporation will receive approximately $5,618,000 per year at the present size of the Fund.

The Fund denies each and every remaining allegation of Paragraph 8.

9. Unlike most other investment companies, the management of the assets of a money market fund, such as the Fund herein, does not require the detailed analysis of industries nor of complex industrial companies and the concomitant retention of a large staff of highly paid and sophisticated securities analysts. Indeed, the assets of the

fund, are and have been, invested in a relatively concentrated manner in fixed income obligations maturing in one year or less. In the ordinary course of operations, decisions to purchase are made on the same day that the funds are received.

ANSWER: 9. The Fund admits that the assets of the Fund are invested in fixed income obligations maturing in one year or less and that, in the ordinary course of operations, decisions to purchase are made on the same day that the funds are received or shortly thereafter.

The Fund denies each and every remaining allegation of Paragraph 9.

10. Despite the huge growth in the size of the Fund, the only changes in the fee structure were made on December 1, 1981 and November 4, 1986 when, in spite of the economies of scale resulting from the Fund's enormous growth, the fees were increased by virtue of the adoption and amendment of the administration agreement.

ANSWER: 10. The Fund admits that the only changes in the fee structure occurred on December 1, 1981 and November 4, 1986. The Fund further admits that in November 1981, the administration, shareholder services and distribution agreement was adopted pursuant to and in accordance with Rule 12b-1 as adopted by the Securities and Exchange Commission under the Act; that the Fund pays fees to KFS pursuant to the terms of the administration, shareholder services and distribution agreement; and that all but a small portion of those fees are paid to various firms that provide services to the shareholders to the Fund. The Fund further admits that the combined investment management and administration, shareholder services and distribution agreements

fee structure, expressed as a combined percentage of the Fund's net assets, was higher after December 1, 1981 than the investment management fee alone was prior to that date. The Fund further admits that the combined investment management and administration, shareholder services and distribution fee structure was higher after the November 4, 1986 changes in the fee structure than it was prior to that date.

The Fund denies each and every remaining allegation of Paragraph 10.

11. As a result of the tremendous increase in the assets of the Fund, the compensation paid and payable to KFS has increased enormously and disproportionately to the services rendered by it.

ANSWER: 11. The Fund denies the allegations of Paragraph 11.

12. In addition to acting as investment manager to the Fund, KFS also acts as an investment manager to numerous other accounts and investment companies. Among those investment companies is Kemper Money Market Fund, Inc. ("MM"). MM, like the Fund, is a money market fund with the identical objective of obtaining maximum current income to the extent consistent with stability of principal. It is approximately the same size as the Fund, has approximately the same number of shareholders, and invests in the same types of securities as does the Fund. The directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund. KFS is the investment adviser, manager, and underwriter for MM and supplies to MM substantially the same services that it supplies or causes to be supplied to the Fund. Yet, KFS exacts substantially greater fees from the Fund than it does from MM and many of its other clients. Thus, in the year ended July 31, 1984, the Fund's expenses were .72% of its average net assets, whereas those of MM were only .53%, and

in every year since 1981 the expenses of the Fund have been significantly greater than those of MM. As a result, the Fund's yield for the year ended September 30, 1984, was approximately 21 basis points less than that of MM, so that the Fund's investment objective of obtaining maximum current income consistent with stability was effectively thwarted by KFS's exaction of exorbitant fees.

ANSWER: 12. The Fund admits that KFS acts as investment manager to the Fund and other accounts and investment companies, including Kemper Money Market Fund ("MM"). The Fund further admits that MM is a money market fund whose objective of obtaining maximum current income to the extent consistent with stability of principal is the same as the Fund, and which invests in substantially the same types of securities as the Fund. The Fund further admits that the directors and many of the officers and other personnel servicing MM are the same as those performing services for the Fund and that KFS is the investment adviser, manager and underwriter for MM. The Fund further admits that, for the year ended July 31, 1984, the ratio of expenses to average net assets was .72% for the Money Market Portfolio and .65% for the Government Securities Portfolio of the Fund.

Further answering, the Fund states that, as of April 23, 1985, the total assets of the Fund were approximately $5,172,000,000, and that, as of May 31, 1985, the Fund had approximately 687,000 shareholders.

The Fund denies each and every remaining allegation of Paragraph 12.

13. On or about September 12, 1984, KFS caused to be distributed to the shareholders of the Fund a proxy statement for the annual meeting of shareholders on

November 8, 1984. One of the principal purposes of the meeting which KFS was eager to accomplish was to obtain shareholder approval of the continuance of the investment management agreement between the Fund and KFS. The shareholders were asked to approve the agreement and were offered no alternative in the event of disapproval. As part of this solicitation, the proxy statement compared the services and fees offered and received by KFS from other investment companies. The proxy statement correctly described the services rendered to MM as being similar to those rendered to the Fund, but it misleadingly described the fees charged to MM as consisting of "a maximum fee of .50 of 1% of the first $215,000,000 with lesser rates on additional assets." This gave the false impression that the fees paid by MM were as high or higher than the fees paid by the Fund, whereas KFS knew that the fees received by it from MM were substantially lower than those received by it from the Fund, and that, in fact, for the year ended July 31, 1984 the fees received by KFS from MM aggregated only .28% of MM's average daily net assets. In disseminating the proxy statement to the shareholders of the Fund, KFS used the mails and means and instrumentalities of interstate commerce in violation of § 20 of the Act. The solicitation was successful, and KFS obtained shareholder approval of its management agreement with the Fund, to the damage of the Fund and its shareholders.

ANSWER: 13. The Fund admits that pursuant to a proxy statement dated September 12, 1984, shareholders of the Fund were asked to approve the continuation of the investment management agreement between the Fund and KFS. The Fund further admits that the proxy statement included the following language: "No consideration has been given to what action would be taken if shareholder approval of the agreement is not received." The

Fund admits that the proxy statement included information regarding rates and fees paid to KFS by other investment companies, including MM. KFS further admits that the shareholders approved the continuation of the investment management agreement.

The Fund denies each and every remaining allegation of Paragraph 13.

14. Because of the limited number, nature and variety of the Fund's investments, the investment decisions of the Fund can be made by a single person, or, at most, a handful of persons. The research and advisory activities of KFS are merely routine and administrative in nature, do not require any significant expertise or investment acumen, are performed (and were performed prior to the formation of the Fund) by KFS for other of its accounts, and consist principally of purchasing and "turning over" money market instruments with a limited number of institutions. The incremental costs to KFS of performing these services for the Fund is minimal. In short, the investment advice provided by KFS is not worth the fees paid for that advice by the Fund and has not been worth the fees paid during the period covered by this Complaint. Other advisers performed and have performed similar or superior services for lesser rates.

ANSWER: 14. The Fund denies the allegations of Paragraph 14.

15. The advisory and management fees paid by the Fund to KFS are exorbitant, unreasonable, excessive and completely disproportionate to the services rendered in return therefor.

ANSWER: 15. The Fund denies the allegations of Paragraph 15.

16. Pursuant to § 36(b) of the Act, KFS has a fiduciary duty with respect to the receipt of compensation from

the Fund. By virtue of the foregoing, KFS has breached its fiduciary duty to the Fund.

ANSWER: 16. The first sentence of Paragraph 16 is a legal conclusion to which answer is not required. The Fund denies the allegations in the second sentence of Paragraph 16.

17. No demand has been made by the plaintiff upon the Fund or its directors to institute or prosecute this action for the following reasons:

(a) With respect to the claims asserted under § 36(b) of the Act, no such demand is required;

(b) The board of directors of the Fund consists of ten members. Of those, three are "interested" as defined by the Act; that is, they have a personal financial interest in KFS. In addition, the president of the Fund, John Hawkinson, was formerly president of KFS and is a stockholder of Kemper Corporation, KFS's parent. Furthermore, the so-called "non-interested" directors currently receive aggregate remuneration of approximately $300,000 a year for serving as directors of the Fund and of all the other funds in the Kemper group. They are dependent upon and subservient to KFS and Kemper Corporation, its parent;

(c) The proxy statement referred to in paragraph 13 above stated: "The accompanying proxy is solicited by the Board of Directors of the Fund . . .", and indeed, the directors did vote, without dissent, to distribute the proxy statement to Fund shareholders. Any suit, such as the instant suit, brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all the directors of the Fund;

(d) Requiring the plaintiff to make a demand on the Fund or its directors to institute or prosecute this action would be futile. It would be tantamount to asking the directors to sue themselves. Moreover, were the directors

to accept such an invitation and institute an action, the prosecution of the action would be in hostile hands inimical to its success;

(e) All of the directors, and the Fund itself, as well as its personnel and policies, are under the control of KFS and Kemper Corporation, its parent;

(f) In responding to the original complaint, the Fund, both in its answer and motion to dismiss, has sought the dismissal of the complaint on substantive grounds;

(g) Under all of the circumstances present in this case, application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act.

ANSWER: 17. The Fund admits that no demand has been made by plaintiff upon the Fund or its trustees to institute this action. Further answering, the Fund states that the allegations contained in subparagraphs 17(a), (d), (e) and (g) are but statements of legal or factual conclusion, to which answer by the Fund is not required.

With respect to subparagraph 17(b), the Fund admits that three (3) of its trustees are "interested" as defined by the Act, admits that "non-interested" trustees are remunerated for their services as trustees of the Fund, admits that John Hawkinson is a stockholder of Kemper Corporation and denies the remaining allegations of subparagraph 17(b).

With respect to subparagraph 17(c), the Fund admits that the proxy statement therein described stated "The accompanying proxy is solicited by the Board of Directors of the Fund . . . " and that the directors voted to distribute the proxy statement to the Fund shareholders. The

remaining allegations of subparagraph 17(c) are conclusions to which no answer is required, and none is made.

With respect to subparagraph 17(f), the Fund admits it seeks dismissal of these proceedings on substantive grounds.

WHEREFORE, defendant CASH EQUIVALENT FUND denies that the plaintiff is entitled to judgment against it in any amount and prays that the supplemental amended complaint be dismissed with prejudice, and that defendant be awarded its costs and attorneys' fees. Defendant further denies that plaintiff is entitled to a trial by jury.

FIRST AFFIRMATIVE DEFENSE

The supplemental amended complaint fails to state a claim upon which relief can be granted.

SECOND AFFIRMATIVE DEFENSE

Plaintiff has failed to state a cause of action on behalf of the Fund under Section 20 of the Investment Company Act of 1940, as amended (15 U.S.C. § 80a-20) because she did not make a demand on the Fund or its directors to initiate suit.

THIRD AFFIRMATIVE DEFENSE

Plaintiff has failed to state a cause of action under Section 20 of the Investment Company Act of 1940, as amended (15 U.S.C. § 80a-20) because no private cause of

action exists under said Section 20 for the allegations in the complaint.

FOURTH AFFIRMATIVE DEFENSE

Plaintiff is not a fair, adequate or proper representative of the shareholders of the Fund and therefore cannot maintain this action.

CASH EQUIVALENT FUND

BY: Martin M. Ruken
One of Its Attorneys

Charles F. Custer
Martin M. Ruken
Vedder, Price, Kaufman & Kammholz
115 S. LaSalle Street
Chicago, IL 60603
312/781-2200

DATED: December 30, 1986

PLAINTIFF'S MOTION FOR RECONSIDERATION DATED FEBRUARY 11, 1987 WITH ATTACHED EXHIBITS

IN THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	Case No. 85 C 4587
v.	)	
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC., Defendants.	)	Judge Nordberg

NOTICE OF FILING

TO: Joan Hall, Esq.
Jenner & Block
One IBM Plaza, 44th Floor
Chicago, Illinois 60611

Arthur J. McGivern, Esq.
Vedder, Price, Kaufman & Kammholf
115 South LaSalle Street
Suite 3000
Chicago, Illinois 60603

PLEASE TAKE NOTICE that on February 11, 1987 we will file with the Clerk of the above Court: Plaintiff's Motion for Reconsideration and Memorandum in Support of Motion for Reconsideration. A copy of the aforementioned documents are attached hereto.

DATED: February 11, 1987

JILL KAMEN, Plaintiff

BY: /s/ Clifford E. Yuknis
One of Her Attorneys

444 North Michigan Avenue
Suite 2300
Chicago, Illinois 60611
(312) 527-4000

OF COUNSEL:

Joel J. Sprayregen
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IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF
ILLINOIS EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	Case No. 85 C 4587
v.	)	
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC., Defendants.	)	Judge Nordberg

PLAINTIFF'S MOTION FOR RECONSIDERATION

NOW COMES plaintiff, Jill S. Kamen, by her attorneys, and moves pursuant to Rule 59 of the Federal Rules of Civil Procedure for the Court to reconsider the February 2, 1987 memorandum opinion and order dismissing plaintiff's Section 20(a) claim and granting defendants' Motion to strike plaintiff's jury demand. In support of this motion, plaintiff states as follows:

1. Plaintiff is filing herewith the attached Memorandum in support of this Motion.

2. With regard to the dismissal of the proxy fraud claim under Section 20(a) of the Investment Company Act, the purpose of this motion is to point out that the allegations of refusal to sue are borne out by the testimony of the disinterested directors. Attached to the memorandum which is being filed in support of this motion are pages from the transcripts of deposition testimony of disinterested directors of Cash Equivalent Fund. It is clear that a majority of the Board of the Cash Equivalent Fund would not have prosecuted the claims asserted in the Complaint.

2. With regard to this Court's granting the defendants' motion to strike the Plaintiff's jury demand, the Memorandum points out that since the First Circuit's decision in *Dairy Queen*, the Supreme Court has leaned in the opposite direction. *Curtis v. Loether*, 405 U.S. 189, 196 (1974).

WHEREFORE, plaintiff prays that the Court (i) reconsider its February 2, 1987 memorandum opinion and order, (2) vacate its February 2, 1987 order, (3) deny the defendants' motion to dismiss the proxy fraud claim and strike the jury demand, and (4) grant plaintiff such other relief it considers proper.

DATED: February 11, 1987

JILL KAMEN, Plaintiff

BY: /s/ Clifford E Yuknis
One of Her Attorneys

444 North Michigan Avenue
Suite 2300
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(312) 527-4000

OF COUNSEL:

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EXHIBIT A

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff, -vs- KEMPER FINANCIAL SERVICES, INC., AND CASH EQUIVALENT FUND, Defendants.	)	No. 85 C 4587

The deposition of THOMAS L. MARTIN, called by the Defendant Kemper Financial Services, Inc. for examination, taken pursuant to the Federal Rules of Civil Procedure of the United States District courts pertaining to the taking of depositions, taken before MARY KAY BELCOLORE, a Notary Public within and for the County of Du Page, State of Illinois, and a Certified Shorthand Reporter of said state, at Suite 4300, One IBM Plaza,

Chicago, Illinois, on the 28th day of October, A.D. 1986, at 9:30 a.m.

* * *

[p. 61] And any such statement coming to us or recommendation to us would be seriously considered.

And I know that that is true of this Board.

So the answer is, if it was in the opinion of the Board justified, I can't see that the Board would have any reason not to.

Q. Well, the Board did consider the complaint, did it not?

A. Yes.

Q. And did it authorize its counsel to take position in the litigation?

A. Yes.

Q. What position did it authorize its counsel to take?

A. To support the action of the Board, that the Board concluded that its recommendation on the fee structure was the correct one.

Q. And so that the Board decided that the funds should not press a claim against KFS?

MS. HALL: That is not what he has testified to.

MR. MEYER: I'm asking that. That is a new question.

BY THE WITNESS:

A. We effectively decided that the complaint [p. 62] of the stockholder was unjustified.

MR. MEYER: I have no further questions at this point.

MS. HALL: I have no questions.

MR. RUKEN: None.

MS. HALL: We are reading and signing.

FURTHER DEPONENT SAITH NOT.

EXHIBIT B

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF
ILLINOIS EASTERN DIVISION

JILL S. KAMEN,	)	
Plaintiff,	)	No. 85 C 4587
v.	)	
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC.,	)	
Defendants.	)	

The deposition of ROBERT BUTLER HOFFMAN, called by the Plaintiff for examination, taken pursuant to the Federal Rules of Civil Procedure of the United States District Courts pertaining to the taking of depositions, taken before SHARYN A. EVERMAN, a Notary Public

within and for the County of Cook, State of Illinois, and a Certified Shorthand Reporter of said state, at Suite 4400, One IBM Plaza, Chicago, Illinois, on the 4th day of November, A.D. 1986, at 9:30 a.m.

* * *

[p. 84] doesn't mean that one wasn't made.

Q. Was any such statement made at any time subsequent to 1981 that you can remember?

A. No, not that I can remember.

Q. I take if from everything that you have said that you believe that the present fees, both the management fees and the 12b-1 plan as proposed and as existing, are appropriate?

A. I do.

Q. And I take it you also believe that the proxy material that has been used to solicit shareholder votes has fully reflected the necessary information?

A. I do.

Q. So that were you asked to commence an action against KFS with respect to the fees or the proxy material, you would not do so, is that correct?

MS. HALL: I object to the hypothetical nature of the question, but the witness may answer subject to the objection.

Would you read the question again?

(WHEREUPON, the record was read by the reporter as requested.)

BY THE WITNESS:

[p. 85] A. Were I to feel that way, which I do not, I would have asked that my vote be shown as a dissenting vote to what is in the minutes. And I – is that clear?

BY MR. MEYER:

Q. I think I know what you mean, but it really isn't clear.

Would you mind restating it?

MS. HALL: Maybe you could rephrase the question.

THE WITNESS: Let me hear the question again.

(WHEREUPON, the record was read by the reporter as requested.)

BY THE WITNESS:

A. I would not do so, that's correct.

MR. MEYER: Off the record.

(WHEREUPON, discussion was had off the record.)

MR. MEYER: One or two more questions.

BY MR. MEYER:

Q. Do you have any understanding whether KFS is prepared to reduce its management fees if the 12b-1 revision is approved by the shareholders today?

* * *

EXHIBIT C

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF
ILLINOIS EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	No. 85 C 4587
v.	)	
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC., Defendants.	)	

The deposition of DONALD L. DUNAWAY, called by the Plaintiff for examination, taken pursuant to the Federal Rules of Civil Procedure of the United States District Courts pertaining to the taking of depositions, taken before MAYLEEN PETERS, a Notary Public within and for the County of Cook, State of Illinois, and a Certified Shorthand Reporter of said state, taken at Suite 4300, One IBM Plaza, Chicago, Illinois, on the 8th day of October, A.D. 1986, at 9:30 a.m.

* * *

[p. 21] BY MR. MEYER:

Q. Yes. And why did you do that?

A. Because in my view, it was in the best interest of the existing shareholders of the Fund to approve it.

Q. Are you familiar with the allegations in the lawsuit in which we are taking this testimony?

A. I think generally, yes.

Q. Are you aware of the lawsuit allegation that the fees presently being paid are excessive?

A. Yes.

Q. Are you also aware that there are allegations in the lawsuit concerning the adequacy of disclosures in the proxy statement?

A. My proxy statement? Do you mean this particular statement?

Q. No, the prior proxy statement.

I will give you the exact one.

(WHEREUPON, there was a short interruption.)

BY MR. MEYER:

Q. The proxy statement of September, 1984?

A. Yes.

Q. What is your view of the allegations in the [p. 22] complaint in those respects?

A. They are incorrect.

Q. So it is fair to say that if you were asked to bring an action against Kemper Financial Services with respect to the allegations in the complaint that you would refuse to do so?

MS. HALL: Would you read the question?

(WHEREUPON, the record was read by the reporter as requested.)

MS. HALL: I am going to object because of the hypothetical nature of the question and advise the witness not to answer.

BY MR. MEYER:

Q. And I take it you are following Ms. Hall's advice, is that right?

A. That's correct.

Q. You have been aware of the pendency of the present lawsuit for some time, is that correct?

A. I missed after aware in there.

Q. Pendency of the present lawsuit for some time.

A. Of its existence, yes.

Q. What action, if any, have you taken with respect to it?

[p. 23] A. What action? What action have I taken? None that I can think of.

Q. Well, did you as a director vote to retain counsel to represent the Fund?

A. Not that I recall.

Q. Did you discuss what position the Fund should take in the lawsuit?

A. Oh, discussed with whom?

MS. HALL: I will advise the witness that he should not answer that question insofar as it might call for conversations with counsel.

BY MR. MEYER:

Q. Excluding counsel, did you discuss, for example, with your co-directors what position the Fund should take in the lawsuit?

MS. HALL: And I would again advise the witness that if that conversation – if there were a conversation with co-directors and it took place during a conversation with counsel that you should not answer that question.

Are you now clear on the question and the objection?

THE WITNESS: And the advice?

MS. HALL: And the advice.

[p. 24] BY MR. MEYER:

Q. What is your answer?

A. I will take Miss Hall's advice.

Q. Well, were there any discussions with your fellow directors as to what position the Fund should take in the lawsuit?

MS. HALL: And, again, I advise you only to answer that question as to conversations with fellow directors which took place outside the presence of counsel.

MR. MEYER: The present question – first of all, I don't think your initial instruction was correct, but the present question asks only whether there were any such conversations.

MS. HALL: You may answer that question.

THE WITNESS: I'm sorry.

Miss, would you read the question back?

(WHEREUPON, the record was read by the reporter as requested.)

BY THE WITNESS:

A. It is not really clear to me what you mean by discussions.

BY MR. MEYER:

Q. Did it come up at a Board meeting or outside

* * *

EXHIBIT D

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	
vs.	)	No. 85 C 4587
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, Defendants.	)	

The deposition of HARRY C. DeMUTH, called by the Plaintiff for examination, taken pursuant to the Federal Rules of Civil Procedure of the United States District Courts pertaining to the taking of depositions, taken

before MELANIE JAKUS, a Notary Public within and for the County of DuPage, State of Illinois, and a Certified Shorthand Reporter of said state, at Suite 4400, One IBM Plaza, Chicago, Illinois, on the 19th day of November, A.D. 1986, at 9:10 a.m.

* * *

[p. 58] A. I understand that somebody feels that the fees are too high. They knew what they were, but they think they are too high. They bought the fund nevertheless.

Q. Do you know whether or not there is any challenge to any proxy statements sent out by the fund?

A. I don't know what the details are of that. I saw that in the information that is presented in the prospectus. I am not familiar with the details of that.

Q. Did you ask KFS for its views of the merits of the action?

A. No, I did not.

Q. Did they give you their views of the merits of the action?

A. They discussed – presented to us – they told us of the fact that there was some litigation and have kept us informed as to the status of it.

Q. And what is your view, if any, of the merits of the litigation?

A. I am not a lawyer. I have no view whatever of that.

Q. Would you consider prosecuting the claims [p. 59] set forth in the litigation against KFS on behalf of the fund?

A. I don't know what the – don't know what they are. I don't know what the –

Q. You don't know what the claims are?

A. Well, the claims are the fees are too high.

Q. And you don't know what the proxy claims are?

A. The proxy claims – I don't know what you mean by proxy claims.

Q. You said you were aware that there were some claims with respect to a proxy statement.

A. I think the litigation is described in the prospectus in your hand.

Q. And that is the extent of your knowledge of it?

A. Yes. Yes.

MR. MEYER: I have no further questions.

FURTHER DEPONENT SAITH NOT.

EXHIBIT E

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN,)
Plaintiff,)
vs.) No. 85 C 4587
KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND,)
Defendants.)

The deposition of DAVID W. BELIN, called by the Plaintiff for examination, taken pursuant to the Federal Rules of Civil Procedure of the United States District Courts pertaining to the taking of depositions, taken before SUSAN M. MARTINO, a Notary Public within and for the County of Cook, State of Illinois, and a Certified Shorthand Reporter of said state, at Suite 4000, One IBM Plaza, Chicago, Illinois, on the 9th day of October, A.D. 1986, at 9:30 a.m.

* * *

[p. 44] litigation at the time of the 1986 increase. I have to be candid with you and tell you I don't think the litigation has any merit, but I was aware of it.

Q. You've seen the complaint, I take it?

A. I've sign the complaint. I've seen the – there is one clause that basically says, as I remember the complaint, something about having a misleading or insufficient information in the proxy statement concerning the

Kemper Money Market Fund. I happen to believe that that is specious.

But I understand that's not your opinion. That's my opinion. I've seen the complaint. With regard to – there is another portion that talks about the investment management fee being excessive. I believe and I think – I may be wrong by a few basis points, I think it's around 17 basis points or something and I think the fee is very reasonable particularly in light of the performance.

So I just really basically disagree as a representative of the independent shareholders that there is any merit, and I think for someone to say that it's misleading – because they refer to Kemper Money Market Fund. It says it has a top rate of 50 basis points and they should have given the whole [p. 45] complete gradation, I just think that's utterly without merit.

Q. So that if you had been asked directly to bring an action against KFS with respect to that claim, you would have refused, is that right?

MS. HALL: Hold your answer. I'm going to advise the witness not to answer that hypothetical question.

MR. MEYER: On what basis?

MS. HALL: On the basis that it's a hypothetical question. He's here to answer – not to answer hypothetical questions.

MR. MEYER: I take it you're following counsel's advice?

(WHEREUPON, discussion was had off the record between the witness and Ms. Hall out of

the hearing of other counsel and the court reporter.)

MS. HALL: I'll withdraw my objection.

BY THE WITNESS:

A. I better have the question back then.

MR. MEYER: I notice that the withdrawal of the objection comes after conference between counsel and [p. 46] the witness.

MS. HALL: The record will reflect that I have consulted with my client.

MR. MEYER: Would you read the question back?

(WHEREUPON, the record was read by the reporter as requested.)

BY THE WITNESS:

A. Not necessarily.

BY MR. MEYER:

Q. Are you telling me there is a chance you would have brought such an action?

A. I'm telling you that right now, I would have to give it some consideration as to whether I would or wouldn't.

Q. Well, you've had the complaint for almost two years and you've come up with the conclusion that the contention is specious.

What consideration is it that you would want to give to such a request?

A. Well, I guess if someone said it – if someone came to me as a shareholder and said that they believed there was some merit, at least I would give it some consideration.

Q. Well, you know that Jill Kamen is a [p. 47] shareholder, don't you?

A. I believe she is. She claims she is.

Q. And she has advanced the claim. Why is it that your reaction to the complaint would be different than your reaction to an informal communication?

A. Well, I'm telling you at least right now what my considered opinion is, and you've said if someone – your question basically – to go back to your specific question, saying I would automatically not do something. I guess I wouldn't automatically respond to it if that claim was brought up.

That's why I said not necessarily. I still believe that based upon at least what I perceive to be the reasonable – well, I'll call the reasonable and prudent shareholder, that this lawsuit really does not have any merit.

Q. Did you participate in any discussions concerning litigation strategy in this lawsuit?

MS. HALL: I'm going to advise the witness to exclude from his answer any conversations with counsel.

MR. MEYER: It's only a yes or no question at

* * *

EXHIBIT F

PART B

STATEMENT OF ADDITIONAL INFORMATION

December 1, 1985

CASH EQUIVALENT FUND
120 South LaSalle Street, Chicago, Illinois 60603
(312) 332-6472

This Part B Statement of Additional information is not a prospectus. It should be read in conjunction with the prospectus of Cash Equivalent Fund (the "Fund") dated December 1, 1985. The prospectus may be obtained without charge from the Fund.

TABLE OF CONTENTS

The financial statements appearing in the Fund's 1985 Annual Report are incorporated herein by reference. The Fund's Annual Report accompanies this Statement of Additional Information.

INVESTMENT RESTRICTIONS

The Fund has adopted for the Money Market Portfolio and the Government Securities Portfolio certain investment restrictions which, together with the investment objective and policies of each Portfolio, cannot be changed for a Portfolio without approval by holders of a majority of its outstanding voting shares. As defined in the Investment Company Act of 1940, this means the lesser of the vote of (a) 67% of the shares of the Portfolio at a meeting where more than 50% of the outstanding shares are present in person or by proxy or (b) more than 50% of the outstanding shares of the Portfolio.

The Money Market Portfolio and the Government Securities Portfolio individually may not:

(1) Purchase securities or make investments other than in accordance with its investment objective and policies.

(2) Purchase securities of any issuer (other than obligations of, or guaranteed by, the United States Government, its agencies or instrumentalities) if, as a result, more than 5% of the value of the Portfolio's assets would be invested in securities of that issuer.

(3) Purchase, in the aggregate with all other Portfolios, more than 10% of any class of securities of any issuer. All debt securities and all preferred stocks are each considered as one class.

(4) Invest more than 5% of the Portfolio's total assets in securities of issuers (other than obligations of, or guaranteed by, the United States Government, its agencies or instrumentalities) which with their predecessors have a record of less than three years continuous operation.

(5) Enter into repurchase agreements if, as a result thereof, more than 10% of the Portfolio's total assets valued at the time of the transaction would be subject to repurchase agreements maturing in more than seven days.

(6) Make loans to others (except through the purchase of debt obligations or repurchase agreements in accordance with its investment objective and policies).

(7) Borrow money except as a temporary measure for extraordinary or emergency purposes and then only in an amount up to one-third of the value of its total assets, in order to meet redemption requests without immediately selling any money market instruments (any such borrowings under this section will not be collateralized). If, for any reason, the current value of the Portfolio's total assets falls below an amount equal to three times the amount of its indebtedness from money borrowed, the Fund will, within three business days, reduce its indebtedness to the extent necessary. The Fund will not borrow for leverage purposes.

(8) Make short sales of securities, or purchase any securities on margin except to obtain such short-term credits as may be necessary for the clearance of transactions.

(9) Write, purchase or sell puts, calls or combinations thereof.

(10) Concentrate more than 25% of the value of the Portfolio's assets in any one industry; provided, however, that the Portfolio reserves freedom of action to invest up to 100% of its assets in certificates of deposit or bankers' acceptances or U.S. Government securities in accordance with its investment objective and policies.

(11) Purchase or retain the securities of any issuer if any of the officers or trustees of the Fund or its investment adviser owns beneficially more than 1/2 of 1% of the securities of such issuer and together own more than 5% of the securities of such issuer.

(12) Invest more than 5% of the Portfolio's total assets in securities restricted as to disposition under the federal securities laws (except commercial paper issued under Section 4(2) of the Securities Act of 1933).

(13) Invest for the purpose of exercising control or management of another issuer.

(14) Invest in commodities or commodity futures contracts or in real estate, although it may invest in securities which are secured by real estate and securities of issuers which invest or deal in real estate.

(15) Invest in interests in oil, gas or other mineral exploration or development programs, although it may invest in the securities of issuers which invest in or sponsor such programs.

(16) Purchase securities of other investment companies, except in connection with a merger, consolidation, reorganization or acquisition of assets.

(17) Underwrite securities issued by others except to the extent the Fund may be deemed to be an underwriter,

under the federal securities laws, in connection with the disposition of portfolio securities.

(18) Issue senior securities as defined in the Investment Company Act of 1940.

If a percentage restriction is adhered to at the time of investment, a later increase or decrease in percentage beyond the specified limit resulting from a change in values or net assets will not be considered a violation.

The Fund did not borrow money as permitted by investment restriction number 7 in its latest fiscal year and has no present intention of borrowing during the coming year. In any event, borrowings will only be as permitted thereby.

INVESTMENT MANAGER AND SHAREHOLDER SERVICES

As stated in the prospectus, Kemper Financial Services, Inc. ("KFS") is the Fund's investment manager. Pursuant to an investment management agreement, KFS acts as the Fund's investment adviser, manages its investments, administers its business affairs, furnishes office facilities and equipment, provides clerical, bookkeeping and administrative services, provides shareholder and information services and permits any of its officers or employees to serve without compensation as trustees or officers of the Fund if elected to such positions. The Fund pays the expenses of its operations, including the fees and expenses of independent auditors, counsel, custodian and transfer agent and the cost of share certificates, reports and notices to shareholders, costs of calculating net asset value, brokerage commissions or transaction

costs, taxes, registration fees, the fees and expenses of qualifying the Fund and its shares for distribution under federal and state securities laws and membership dues in the Investment Company Institute or any similar organization.

The investment management agreement continues in effect from year to year so long as its continuation is approved at least annually by a majority of the trustees who are not parties to such agreement or interested persons of any such party except in their capacity as trustees of the Fund and by the shareholders or the Board of Trustees. It may be terminated at any time upon 60 days notice by either party, or by a majority vote of the outstanding shares of a Portfolio with respect to that Portfolio, and will terminate automatically upon assignment. Shares will be voted by Portfolio on the investment management agreement.

For the services and facilities furnished, the Fund pays an annual investment management fee, payable monthly, on a graduated basis of .22 of 1% of the first $500,000,000 of average daily net assets, .20 of 1% on the next $500,000,000, .175 of 1% on the next $1 billion, .16 of 1% on the next $1 billion and .15 of 1% on average daily net assets over $3 billion. KFS has agreed to reimburse the Fund should all operating expenses of the Fund, including the investment management fee of KFS but excluding taxes, interest, extraordinary expenses (as determined by the Board of Trustees) and brokerage commissions or transaction costs, exceed .90 of 1% of the first $500 million, .80 of 1% of the next $500 million, .75 of 1% of the next $1 billion and .70 of 1% of average daily net assets in excess of $2 billion on an annual basis. In addition, the

Fund has undertaken to a state securities authority that expenses (with the aforesaid exclusions) will not exceed 25% of the Fund's total income while its shares are registered for sale in that state. The investment management fee and the expense limitation are computed based on average daily net assets of all Portfolios of the Fund managed by KFS and are allocated among such Portfolios based upon the relative net assets of each, and the net asset value of Fund shares is computed on a Portfolio by Portfolio basis. For its services as investment adviser and manager and for facilities furnished the Fund during the year ended July 31, 1985, the Fund incurred investment management fees aggregating $7,710,000 for the Money Market Portfolio and $781,000 for the Government Securities Portfolio. The Fund incurred investment management fees of $6,792,000 and $7,638,000 for the Money Market Portfolio and $689,000 and $839,000 for the Government Securities Portfolio for 1984 and 1983, respectively.

Pursuant to an administration, shareholder services and distribution agreement ("administration agreement"), KFS serves as primary administrator to the Fund to provide information and services for existing and potential shareholders. The administration agreement provides that KFS shall appoint various firms to provide a cash management service for their customers or clients through the Fund. The firms are to provide such office space and equipment, telephone facilities, personnel and literature distribution as is necessary or appropriate for providing information and services to the firms' clients. Terms of continuation, termination and assignment under this agreement are identical to those described above with regard to the investment management agreement,

except that termination other than upon assignment requires six months notice. For its services as primary administrator, the Fund pays KFS an annual fee, payable monthly, on a graduated basis of .33 of 1% of the first $500 million of average daily net assets, .30 of 1% on the next $500 million, .275 of 1% on the next $1 billion, .265 of 1% on the next $1 billion and .25 of 1% on average daily net assets over $3 billion.

KFS has related services agreements with various firms to provide cash management and other services for the Fund shareholders. Such services and assistance may include, but not be limited to, establishment and maintenance of shareholder accounts and records, processing purchase and redemption transactions, providing automatic investment in Fund shares of client account balances, answering routine inquiries regarding the Fund, assisting clients in changing account options, designations and addresses, and such other services as may be agreed upon from time to time and as may be permitted by applicable statute, rule or regulation. KFS may enter into administration agreements with banking firms to provide the above listed services, except for certain distribution services which the banks may be prohibited from providing, for their clients who wish to invest in the Fund. KFS may also provide some of the above services for the Fund. KFS pays such firms at a minimum annual rate equal to .25 of 1% of average net assets of those accounts which they maintain and service. KFS may in its discretion pay these firms additional amounts up to the maximum administration fees attributable to accounts maintained by each such firm. It is the present intention of KFS that it will normally pay to the firms a majority of

the amount available for discretionary payments. However, KFS may also elect to keep a portion of the total administration fee to reimburse itself for functions performed for the Fund or to pay for sales materials or other promotional activities.

KFS may also enter into other related services agreements with other firms which will provide a more limited cash management service to their clients. Such services and assistance may include, but not be limited to, processing purchase and redemption transactions in Fund shares for firm clients, answering routine client inquiries regarding the Fund, providing assistance to clients in changing account options, designations and addresses, and such other services as may be agreed upon from time to time. KFS will pay each such firm a quarterly fee at the annual rate of .10 of 1% or .15 of 1% based on average aggregate assets in Fund accounts the firm services.

For the year ended July 31, 1985, the Fund incurred administration fees in the Money Market Portfolio and the Government Securities Portfolio of $12,366,000 and $1,252,000, respectively, of which KFS remitted $12,060,000 and $1,249,000 respectively, to various firms, including $3,025,000 paid to broker-dealer firms affiliated with Kemper Corporation, pursuant to the related services agreements. Effective February 1, 1985, DST Systems, Inc., the Fund's shareholder service agent, entered into an agreement with KFS whereby KFS provides certain shareholder and transfer agency services for the Fund. For the six months ended July 31, 1985, KFS earned $186,000 for services provided for the Fund.

KFS is the principal underwriter for shares of the Fund and acts as agent of the Fund in the sale of its shares. The Fund pays the cost for the prospectus and shareholder reports to be set in type and printed for existing shareholders, and KFS pays for the printing and distribution of copies thereof used in connection with the offering of shares to prospective investors. KFS also pays for supplementary sales literature and advertising costs. Terms of continuation, termination and assignment under the underwriting agreement are identical to those described above with regard to the investment management agreement, except that termination other than upon assignment requires six months notice.

Messrs. Anderson, Harding, Kierscht, Wilson, Williams, Cole, Buecking, Rachwalski, Duffy and Engling are also directors or officers of KFS as indicated under "Officers and Trustees."

Custodian. The United Missouri Bank of Kansas City, N.A., Tenth and Grand, Kansas City, Missouri, as custodian has custody of all securities and cash of the fund; and it attends to the collection of principal and income, and payment for and collection of proceeds of securities bought and sold by the Fund.

Accountants and Reports to Shareholders. The Fund's independent public accountants are Arthur Young & Company, One IBM Plaza, Chicago, Illinois 60611, who audit and report on the Fund's annual financial statements, review certain regulatory reports and the Fund's federal income tax return, and perform other professional accounting, auditing, tax and advisory services when engaged to do so by the Fund. Shareholders will receive

annual audited financial statements and semi-annual unaudited financial statements.

PORTFOLIO TRANSACTIONS

Portfolio transactions are undertaken principally to pursue the Fund's objective in relation to movements in the general level of interest rates, to invest money obtained from the sale of Fund shares, to reinvest proceeds from maturing portfolio securities and to meet redemptions of Fund shares. This may increase or decrease the yield of the Fund depending upon management's ability to correctly time and execute such transactions. Since the Fund's assets will be invested in securities with short maturities, its portfolio will turn over several times a year. Since securities with maturities of less than one year are excluded from required portfolio turnover rate calculations, each Portfolio's portfolio turnover rate for reporting purposes will be zero.

KFS, in effecting purchases and sales of portfolio securities for the account of the Fund, will implement the Fund's policy of seeking the best execution of orders. The Fund expects that purchases and sales of securities for the Fund's Portfolios usually will be principal transactions. Portfolio securities will normally be purchased directly from the issuer or from an underwriter or market maker for the securities. There usually will be no brokerage commissions paid by the Fund for such purchases. Purchases from underwriters will include a commission or concession paid by the issuer to the underwriter, and purchases from dealers serving as market makers will include the spread between the bid and asked prices. The

primary consideration in the allocation of transactions is prompt execution of orders in an effective manner at the most favorable price.

The investment decisions for the Fund are reached independently from those for other accounts managed by KFS. Such other accounts may also make investments in instruments or securities at the same time as the Fund. When two or more accounts have funds available for investment in similar instruments, available instruments are allocated as to amount in a manner considered equitable to each. In some cases this procedure may affect the size or price of the position obtainable for the Fund. However, it is the opinion of the Board of Trustees that the benefits available because of KFS' organization outweigh any disadvantages that may arise from exposure to simultaneous transactions.

Kemper Corporation owns all the outstanding stock of KFS. Kemper Corporation or affiliates also own broker-dealer firms ("affiliated broker-dealers"). No portfolio transactions are executed for the Fund with or through any affiliated broker-dealers. The Fund may purchase securities from other members of an underwriting syndicate of which an affiliated broker-dealer is a participant, but only under conditions set forth in applicable rules of the Securities and Exchange Commission and in accordance with procedures adopted and reviewed periodically by the Board of Trustees.

PURCHASE AND REDEMPTION OF SHARES

Fund shares are sold at their net asset value next determined after an order and payment are received in the

form described in the Fund's prospectus. The minimum initial investment is $1,000 and the minimum subsequent investment is $100 but such minimum amounts may be changed at any time. The Fund may waive the minimum for purchases by trustees, directors, officers or employees of the Fund or KFS. An investor wishing to open an account should use the Account Information Form available from the Fund, investment dealers or other firms.

Upon receipt by DST Systems, Inc., the Fund's shareholder service agent, of a request for redemption, shares will be redeemed by the Fund at the applicable net asset value as described in the Fund's prospectus. If effected at the close of the New York Stock Exchange ("Exchange") the shareholder will receive that day's dividend. A shareholder may elect to use either the regular or expedited redemption procedures.

If shares to be redeemed were purchased by check, the Fund may delay transmittal of redemption proceeds until such time as it has assured itself that good payment has been collected for the purchase of such shares, which will generally be within 15 days. Shareholders may not use expedited redemption procedures (wire transfer or Redemption Draft) until the shares being redeemed have been on the Fund's books for at least 15 days. If shares being redeemed were originally purchased by wiring Federal Funds such delay will be eliminated. Shareholders redeeming shares by expedited wire redemption request between 11 a.m. and 1 p.m. can request to receive the net asset value calculated at 1 p.m. in which case they would not receive that day's dividend. The wire will still be sent on the next business day.

The Fund may suspend the right of redemption or delay payment more than seven days (a) during any period when the Exchange is closed (other than customary weekend and holiday closings), (b) when trading in the markets the Fund normally utilizes is restricted, or an emergency exists as determined by the Securities and Exchange Commission so that disposal of the Fund's investments or determination of its net asset value is not reasonably practicable, or (c) for such other periods as the Securities and Exchange Commission by order may permit for protection of the Fund's shareholders.

DIVIDENDS AND STANDARD YIELD CALCULATIONS

Dividends. On each day that the New York Stock Exchange ("Exchange") is open, each Portfolio's net investment income will be declared at the close of the Exchange as a daily dividend to shareholders of record prior to the close of the Exchange. Shareholders will receive dividends in additional shares unless they elect to receive cash. Dividends will be reinvested monthly at the net asset value on the fifteenth day of each month if a business day, otherwise on the next business day. If cash payment is requested, checks will be mailed within five business days after the above described date. If a shareholder redeems his entire account, all dividends accrued to the time of the redemption will be paid to him not later than the next dividend payment date.

Each Portfolio calculates its dividends based on it daily net investment income. For this purpose, the net investment income of the Portfolio consists of (1) accrued interest income plus or minus amortized purchase discount or

premium, (2) plus or minus all short-term realized and unrealized gains and losses on investments and (3) minus accrued expenses allocated to the Portfolio. Expenses of the Fund are accrued each day. While each Portfolio's investments are valued at amortized cost, there will be unrealized gains or losses on such investments. However, should the net asset value deviate significantly from market value, the Board of Trustees could decide to value the investments at market value and then unrealized gains and losses would be included in (2) above.

Dividends are reinvested monthly and shareholders will receive monthly confirmation of dividends and of purchase and redemption transactions.

Standard Yield Calculations. Each Portfolio's standard yield quotations as they appear in advertising and sales materials are calculated by a standard method prescribed by rules of the Securities and Exchange Commission. Under that method, the current yield quotation is based on a seven day period and computed as follows: Each Portfolio's net investment income per share (accrued interest on portfolio securities, plus or minus amortized purchase discount or premium, less accrued expenses) is divided by the price per share (expected to remain constant at $1.00) during the period ("base period return") and the result is divided by 7 and multiplied by 365 and the current yield figure carried to the nearest one-hundredth of one percent. Realized capital gains or losses and unrealized appreciation or depreciation of the Fund's portfolio are not included in the calculation. The compounded effective yield is determined by taking the base

period return and calculating the effect of assumed compounding. [The formula for the compounded effective yield is $(\text{based period return} + 1)^{365/7}-1$.]

Each Portfolio's yield fluctuates; and the publication of an annualized yield quotation is not a representation as to what an investment in either Portfolio will actually yield for any given future period. Actual yields will depend not only on changes in interest rates on money market instruments during the period in which the investment in either Portfolio is held, but also on such matters as any realized gains and losses and changes in Portfolio expenses.

OFFICERS AND TRUSTEES

The officers and trustees of the Fund, their principal occupations for the last five years and their affiliations, if any, with Kemper Financial Services, Inc., are as follows:

CHARLES M. KIERSCHT, President and Trustee*, 120 South LaSalle Street, Chicago; President, Chief Operating Officer and Director, Kemper Financial Services, Inc.

THOMAS R. ANDERSON, Vice President and Trustee*, 120 South LaSalle Street, Chicago; Chairman, Chief Executive Officer and Director, Kemper Financial Services, Inc.; Senior Vice President and Director, Kemper Corporation and Lumbermens Mutual Casualty Company; Director or Officer of various Kemper Group Companies

DAVID W. BELIN, Trustee, 2000 Financial Center, 7th and Walnut, Des Moines, Iowa; Partner, Belin, Harris, Helmick, Heartney & Tesdell, Attorneys

LEWIS A. BURNHAM, Trustee, 5610 LaSalle Street, Tampa, Florida; Executive Vice President, Anchor Glass Container Company

HARRY C. DeMUTH, Trustee, 9515 Seymour, Schiller Park, Illinois; Chairman and Director, DeMuth Steel Products Company

DONALD L. DUNAWAY, Trustee, 3533 North 27th Street, Milwaukee, Wisconsin; Senior Vice President, A.O. Smith Corporation

JAMES W. HARDING, Trustee*, 120 South LaSalle Street, Chicago; retired, formerly President and Director, Kemper Corporation; Director, Kemper Financial Services, Inc.

ROBERT B. HOFFMAN, Trustee, 50 Cedar Street, Chicago; Vice President and Chief Financial Officer, Staley Continental, Inc.; formerly Executive Vice President, Castle and Cooke, Inc.; formerly Vice President – Finance, FMC Corporation

THOMAS L. MARTIN, JR., Trustee, 3300 South Federal Street, Chicago; President, Illinois institute of Technology

WILLIAM P. SOMMERS, Trustee, 555 California Street, San Francisco, California; Executive Vice President and Director, Booz, Allen & Hamilton Inc.

GORDON P. WILSON, Vice President*, 120 South LaSalle Street, Chicago; Executive Vice President, Chief Investment Officer and Director, Kemper Financial Services, Inc.

THOMAS V. WILLIAMS, JR., Vice President*, 120 South LaSalle Street, Chicago; Senior Vice President, Kemper Financial Services, Inc.

GERALD M. COLE, Vice President*, 120 South LaSalle Street, Chicago; Senior Vice President, Kemper Financial Services, Inc.

WILLIAM R. BUECKING, Vice President*, 120 South LaSalle Street, Chicago; Senior Vice President and Director of the Fixed Income Department, Kemper Financial Services, Inc.

FRANK J. RACHWALSKI, Vice President*, 120 South LaSalle Street, Chicago; Vice President, Kemper Financial Services, Inc.

JOHN STUEBE, Vice President*, 120 South LaSalle Street, Chicago; Portfolio Manager, Kemper Financial Services, Inc.

CHARLES F. CUSTER, Vice President and Assistant Secretary*, 115 South LaSalle Street, Chicago; Partner, Vedder, Price, Kauffman & Kammholz, Attorneys, Legal Counsel to the Fund

JEROME L. DUFFY, Treasurer*, 120 South LaSalle Street, Chicago; Vice President, Kemper Financial Services, Inc.

ROBERT J. ENGLING, Vice President and Secretary*, 120 South LaSalle Street, Chicago; Attorney, Senior Vice President, Secretary and General Counsel, Kemper Financial Services, Inc.

*Interested persons as defined in the Investment Company Act of 1940.

The officers and trustees of the Fund serve in similar capacities with other Kemper Mutual Funds. The trustees and officers affiliated with KFS receive no compensation from the Fund. The Fund paid or accrued total directors' fees of approximately $48,000 for the year ended July 31,

1985 to those trustees who are not designated above as "interested persons." Certain of these trustees have entered into deferred compensation agreements with the Fund under which payment of the current fees is deferred. Deferred amounts accrue interest each fiscal quarter at the 90-day U.S. Treasury Bill rate in effect at the beginning of such quarter. On August 31, 1985 the officers and trustees of the Fund, as a group, owned less than 1% of the then outstanding shares of the Fund and no person owned of record 5% or more of the Fund's outstanding shares.

SPECIAL FEATURES

Exchange Privilege

Shares of the listed Kemper Mutual Funds may be exchanged for each other at relative net asset values. However, shares of the funds designated* which were acquired by direct investment are subject to the applicable sales charge on exchange. Shares of the funds designated † which were acquired by direct investment must be held for 6 months before they may be exchanged. Shares acquired by purchase transactions may not be exchanged until they have been owned at least 15 days. The exchange privilege is not a right and may be denied or modified. Kemper California Tax-Free Income Fund, Inc. is available on exchange only to California residents.

Technology Fund, Inc.
Kemper Total Return Fund, Inc.
Kemper Growth Fund, Inc.
Kemper Summit Fund, Inc.
Kemper International Fund, Inc.
Kemper Option Income Fund, Inc.

† Kemper Municipal Bond Fund, Inc.
† Kemper Income and Capital Preservation Fund, Inc.
† Kemper U.S. Government Securities Fund, Inc.
† Kemper High Yield Fund, Inc.
† Kemper California Tax-Free Income Fund, Inc.
*Kemper Money Market Fund
*Kemper Government Money Market Fund
*Cash Equivalent Fund
*Tax-Exempt Money Market Fund, Inc.

The total value of shares being exchanged must at least equal the minimum investment requirement of the fund into which they are being exchanged. Exchanges are made based on relative dollar values of the shares involved in the exchange. There is no service fee for an exchange; however, dealers may charge for their services in expediting exchange transactions. Exchanges will be effected by redemption of shares of the fund held and purchase of shares of the other fund. For Federal income tax purposes, any such exchange constitutes a sale upon which a gain or loss will be realized, depending upon whether the value of the shares being exchanged is more or less than the shareholder's adjusted cost basis. Shareholders interested in exercising the exchange privilege may obtain an exchange form and prospectuses of the other funds from investment dealers or KFS. Exchanges may also be authorized by telephone if a preauthorized exchange form, available from KFS, is on file with DST. The exchange privilege may be modified or discontinued at any time.

Systematic Withdrawal Program

The owner of $5,000 or more of a Portfolio's shares may provide for the payment from his account of any requested dollar amount to be paid to him or his designated payee monthly, quarterly or annually. Dividend distributions will be automatically reinvested at net asset value on the record-reinvestment date. A sufficient number of full and fractional shares will be redeemed to make the designated payment. Depending upon the size of the payments requested, redemptions for the purpose of making such payments may reduce or even exhaust the account. The program may be amended on thirty days notice by the Fund and may be terminated at any time by the shareholder or the Fund.

Retirement Programs

Individual Retirement Accounts ("IRA's") are available for individuals whether or not they are active participants in any other tax-qualified employer plan. Individuals may contribute and deduct from gross income up to 100% of compensation received during a year or $2,000, whichever is less. Earnings on amounts held in IRA's accumulate tax deferred. However, there is a 10% penalty on withdrawals before age 59½, unless disabled, Investors Fiduciary Trust Company, P.O. Box 1356, Kansas City, Missouri 64141, has agreed to act as trustee for IRA's which invest in the Fund and utilize IRS Form 5305 for a fee of $10 a year.

Certain employers may provide retirement benefits for employees and minimize federal filing and reporting requirements by adopting a Simplified Employee Pension

Plan ("SEP") under which an employer may make tax-deductible contributions to IRA's established by its employees. The maximum amount which may be contributed by an employer for an employee is the lesser of 15% of compensation or $30,000. In addition, each employee may contribute his own tax-deductible contribution of up to $2,000 as described above.

An employer who has established a pension or profit-sharing plan for employees may purchase Fund shares for such a plan. Forms and additional information for those individuals and institutions wishing to purchase shares of the Fund in conjunction with a tax-deferred retirement plan are available through the Fund to be used as a guide for the investor's own tax adviser.

Automatic Investment Programs

A shareholder may provide for periodic payment of designated amounts ($25 minimum) from his checking account with a bank to his existing fund account. There is no charge for this service.

Shareholder, whose bank is a member of an automated clearing house may be able to have paychecks automatically invested in Fund shares each pay period.

SHAREHOLDER RIGHTS

The Fund is generally not required to hold meetings of its shareholders. Under the Agreement and Declaration of Trust of the Fund ("Declaration of Trust"), however, shareholder meetings will be held in connection with the following matters: (1) the election or removal of trustees

if a meeting is called for such purpose; (2) the adoption of any contract for which approval is required by the 1940 Act; (3) any termination of the Fund to the extent and as provided in the Declaration of Trust; (4) any amendment of the Declaration of Trust (other than amendments changing the name of the Fund or any Portfolio, supplying any omission, curing any ambiguity or curing, correcting or supplementing any defective or inconsistent provision thereof); (5) as to whether a court action, proceeding or claim should or should not be brought or maintained derivatively or as a class action on behalf of the Fund or the shareholders, to the same extent as the stockholders of a Massachusetts business corporation; and (6) such additional matters as may be required by law, the Declaration of Trust, the By-laws of the Fund, or any registration of the Fund with the Securities and Exchange Commission or any state, or as the trustees may consider necessary or desirable. The shareholders also would vote upon changes in fundamental investment objectives, policies or restrictions.

Each trustee serves until the next meeting of shareholders, if any, called for the purpose of electing trustees and until the election and qualification of his successor or until such trustee sooner dies, resigns, retires or is removed by a majority vote of the shares entitled to vote (as described below) or a majority of the trustees. In accordance with the 1940 Act (i) the Fund will hold a shareholder meeting for the election of trustees at such time as less than a majority of the trustees have been elected by shareholders, and (ii) if, as a result of a vacancy in the Board of Trustees, less than two-thirds of

the trustees have been elected by the shareholders, that vacancy will be filled only by a vote of the shareholders.

Trustees may be removed from office by a vote of the holders of a majority of the oustanding [sic] shares at a meeting called for that purpose, which meeting shall be held upon the written request of the holders of not less than 10% of the outstanding shares. Upon the written request of ten or more shareholders who have been such for at least six months and who hold shares constituting at least 1% of the outstanding shares of the Fund stating that such shareholders wish to communicate with the other shareholders for the purpose of obtaining the signatures necessary to demand a meeting to consider removal of a trustee, the Fund has undertaken to disseminate appropriate materials at the expense of the requesting shareholders.

The Declaration of Trust provides that the presence at a shareholder meeting in person or by proxy of at least 30% of the shares entitled to vote on a matter shall constitute a quorum. Thus, a meeting of shareholders of the Fund could take place even if less than a majority of the shareholders were represented on its scheduled date. Shareholders would in such a case be permitted to take action which does not require a larger vote than a majority of a quorum, such as the election of trustees and ratification of the selection of auditors. Some matters requiring a larger vote under the Declaration of Trust, such as termination or reorganization of the Fund and certain amendments of the Declaration of Trust, would not be affected by this provision; nor would matters which under the 1940 Act require the vote of a "majority of the outstanding voting securities" as defined in the 1940 Act.

The Declaration of Trust specifically authorizes the Board of Trustees to terminate the Fund (or any Portfolio) by notice to the shareholders without shareholder approval.

Under Massachusetts law, shareholders of a Massachusetts business trust could, under certain circumstances, be held personally liable for obligations of the Fund. The Declaration of Trust, however, disclaims shareholder liability for acts or obligations of the Fund and requires that notice of such disclaimer be given in each agreement, obligation, or instrument entered into or executed by the Fund or the trustees. Moreover, the Declaration of Trust provides for indemnification out of Fund property for all losses and expenses of any shareholder held personally liable for the obligations of the Fund and Fund will be covered by insurance which the trustees consider adequate to cover foreseeable tort claims. Thus, the risk of a shareholder incurring financial loss an account of shareholder liability is considered remote, since it is limited to circumstances in which a disclaimer is inoperative and the Fund itself is unable to meet its obligations.

The law firm of Ropes & Gray, Boston, Massachusetts, which supervised the organization of the Fund under Massachusetts law, is of the opinion that, pursuant to Massachusetts law, shareholders will not be liable personally for contract claims made under any agreement, obligation or undertaking governed by Massachusetts law and containing such disclaimer or when adequate notice is otherwise given.

Appendix

COMMERCIAL PAPER RATINGS

A-1, A-2 and Prime-1, Prime-2 Commercial Paper Ratings

Commercial paper rated by Standard & Poor's Corporation has the following characteristics: Liquidity ratios are adequate to meet cash requirements. Long-term senior debt is rated "A" or better. The issuer has access to at least two additional channels of borrowing. Basic earnings and cash flow have an upward trend with allowance made for unusual circumstances. Typically, the issuer's industry is well established and the issuer has a strong position within the industry. The reliability and quality of management are unquestioned. Relative strength or weakness of the above factors determine whether the issuer's commercial paper is rated A-1, A-2 or A-3.

The ratings Prime-1 and Prime-2 are the two highest commercial paper ratings assigned by Moody's investors Service, Inc. Among the factors considered by them in assigning ratings are the following: (1) evaluation of the management of the issuer; (2) economic evaluation of the issuer's industry or industries and an appraisal of speculative-type risks which may be inherent in certain areas; (3) evaluation of the issuer's products in relation to competition and customer acceptance; (4) liquidity; (5) amount and quality of long-term debt; (6) trend of earnings over a period of ten years; (7) financial strength of a parent company and the relationships which exist with the issuer; and (8) recognition by the management of obligations which may be present or may arise as a result of public interest questions and preparations to meet such

obligations. Relative strength or weakness of the above factors determines whether the issuer's commercial paper is rated Prime-1, 2 or 3.

STANDARD & POOR'S BOND RATINGS, CORPORATE BONDS

AAA. This is the highest rating assigned by Standard & Poor's to a debt obligation and indicates an extremely strong capacity to pay principal and interest.

AA. Bonds rated AA also qualify as high-quality debt obligations. Capacity to pay principal and interest is very strong, and in the majority of instances they differ from AAA issues only in small degree.

A. Bonds rated A have a strong capacity to pay principal and interest, although they are somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions.

MOODY'S BOND RATINGS

Aaa. Bonds which are rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as "gilt-edge." Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.

Aa. Bonds which are rated Aa are judged to be of high quality be all standards. Together with the Aaa group they comprise what are generally known as high grade

bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long term risks appear somewhat larger than in Aaa securities.

A. Bonds which are rated A possess many favorable investment attributes and are to be considered as upper medium grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggest a susceptibility to impairment sometime in the future.

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

JILL S. KAMEN, Plaintiff,	)	
v.	)	No. 85 C 4587 Judge Nordberg
KEMPER FINANCIAL SERVICES, INC. and CASH EQUIVALENT FUND, INC., Defendants.	)	

KEMPER FINANCIAL SERVICES, INC.'S RESPONSE TO PLAINTIFF'S MOTION FOR RECONSIDERATION

Kemper Financial Services, Inc. ("KFS"), by its attorneys, submits this response to the plaintiff's motion to reconsider the February 2, 1987 memorandum opinion and order entered by this Court. For the reasons set forth below, this motion should be denied.

I. Introduction and Legal Standard.

On February 2, 1987, this Court entered an order dismissing plaintiff's claim under Section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), for failure to make a demand upon the Board of Directors, and striking her jury demand. In a 23 page opinion, this Court addressed all of the issues that had been raised by counsel in their briefs and other written submissions to the Court. Notwithstanding this thorough opinion, and with no attention to the detailed reasoning expressed in the Court's opinion, plaintiff has filed a motion for reconsideration. Plaintiff's motion is plainly without merit.

The law is well established that a motion for reconsideration should be granted only when the Court's decision is clearly erroneous or a significant change has occurred in the law or facts. *Refrigeration Sales Co. v. Mitchell-Jackson Co.*, 605 F.Supp. 6, 7 (N.D. Ill. 1983); *Instituto Nacional v. Continental Illinois National Bank and Trust Company of Chicago*, 576 F. Supp. 991, 1001 (N.D. Ill. 1984); *Polys v. National Broadcasting Co.*, No. 80 C 2475, slip op. at 1-2 (N.D. Ill. February 4, 1985) (attached as Exhibit A). Plaintiff cannot merely rehash old arguments already rejected by the Court. *Id.; Above the Belt, Inc. v. Mel Bohannan Roofing, Inc.*, 99 F.R.D. 99, 101 (E.D.Va. 1983). Under these standards, plaintiff's motion clearly lacks any validity.

II. This Court Properly Dismissed The Section 20(a) Claim.

Because plaintiff failed to make a demand upon the Board of Directors and because plaintiff's complaint failed to allege with specificity, as required by Rule 23.1 of the Federal Rules of Civil Procedure, any reason for not making a demand, this Court correctly dismissed plaintiff's claim under Section 20(a) of the Investment Company Act.

Plaintiff now argues that this Court erred in finding that her allegations regarding the futility of making a demand were "conclusory" or "mere speculation." (Pl.Mem. p. 1-2, quoting the Court's opinion at p. 18). However, plaintiff makes no reference to the allegations in her complaint, which are the only matters relevant to

the motion to dismiss. Rather, plaintiff quotes from transcripts containing deposition testimony of various outside directors. This testimony is irrelevant. As this Court noted, "Kamen thrust the Fund into an adversary role when she instituted this action" (opinion, p. 19), and the fact that the Directors now disagree with her allegations is of no significance.

On December 8, 1986, plaintiff filed a supplemental amended complaint. At that time, the depositions of the outside directors had been completed. However, the supplemental amended complaint added no allegation with respect to the futility of making a demand. Undoubtedly, plaintiff's counsel recognized at that timè, and knows now, that the deposition testimony is not relevant to this issue. Plaintiff's motion to reconsider is without merit and merely is designed to increase the defendant's costs in defending this action.

Moreover, the relevant question in deciding whether a demand is futile is not whether the directors would have agreed with the plaintiff, but whether the disinterested directors would have acted fairly in evaluating the merits of plaintiff's allegations. The purpose of Rule 23.1 is to insure that the decision to initiate litigation is made by the Board of Directors and not by an individual shareholder. (Opinion, p. 13); *Hawes v. City of Oakland*, 104 U.S. 450, 460 (1882). Plaintiff has failed to present any specific fact demonstrating that the disinterested directors would have been biased, unfair or incapable of exercising independent judgment in considering her allegations of wrongdoing, if those allegations properly

had been presented to the Board of Directors.[1] This Court correctly dismissed the § 20(a) claim for failure to make a demand on the Board of Directors.

III. This Court Properly Struck The Jury Demand

Plaintiff's argument with respect to the Court's determination to strike the jury demand also is without merit. Plaintiff makes no effort to explain why this Court should not have followed the rulings in *In re Evangelist*, 760 F.2d 27 (1st Cir. 1985) and *In re Gartenberg*, 636 F.2d 16 (2d Cir. 1980), the two decisions directly on point. Instead, plaintiff refers to language in *Curtis v. Loether*, 415 U.S. 189 (1974) and asserts that "the relief sought" is a most important factor to consider in determining whether to grant a jury trial. (Pl.Mem. p.4). Clearly, the language in *Curtis* does not overrule *Dairy Queen, Inc. v. Wood*, 369 U.S. 469, 477-78 (1962), where the Court stated that "the constitutional right to a trial by jury cannot be made to depend on the choice of words used in the pleadings."

In fact, the opinion in *Curtis v. Loether* is consistent with *Dairy Queen* and with this Court's opinion which plaintiff now seeks to have set aside. *Curtis* was an action for actual and punitive damages based on alleged housing discrimination, which the Court noted "sounds basically in tort." 415 U.S. at 195. Thus, regardless of how

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[1] Indeed, the deposition testimony of Director David W. Belin specifically demonstrates the willingness of the Board to consider any shareholder complaint. Mr. Belin stated, "if someone came to me as a shareholder and said that they believed there was some merit, at least I would give it some consideration." Belin Tr. p. 46, attached to Pl.Mem. at Ex. E.

the relief was denominated by the plaintiff the Court recognized the relief sought as "the traditional form of relief offered in the courts of law." *Id.* at 196. Moreover, this Court addressed the issues raised by *Curtis* (which was cited extensively at pages 15-16 in plaintiff's brief filed on July 23, 1985) in its opinion. (Opinion pp. 22-23). This Court examined the relief actually being sought – restitution of any excessive fees – and found this to be relief traditionally addressed by courts of equity. Although the relief requested is a major factor in determining whether the right to a jury trial exists, restitutionary relief for the breach of a fiduciary duty is equitable in nature and is not transformed by using the word "damages" in the prayer for relief. To hold otherwise would make the constitutional right to a jury depend upon the language in the complaint.

CONCLUSION

Plaintiff's motion to reconsider is without any merit. No significant change in the law or facts has occurred and this Court's decision is not clearly erroneous. Indeed, the opinion is in accord with applicable law and precedent. Because the motion attempts to reargue points which were addressed in this Court's opinion and because it plainly does not meet the established legal

standards for a motion for reconsideration, the motion should be denied.

Respectfully submitted,

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Dated: February 23, 1987

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No. 90-516

In The

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR PETITIONER

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QUESTION PRESENTED FOR REVIEW

As a prerequisite to bringing a shareholder action on behalf of an investment company to recover damages for proxy fraud under Section 20 of the Investment Company Act, must the shareholder first make a demand upon the company's directors to bring the action even where such a demand would be futile?

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OPINIONS BELOW

The opinion of the Court of Appeals for the Seventh Circuit is reported at 908 F.2d 1338. The opinion of the District Court for the Northern District of Illinois is reported at 659 F. Supp. 1153 (February 2, 1987). The final judgment of the District Court was entered September 1, 1989.

JURISDICTION

The judgment of the Court of Appeals was entered on July 18, 1990. A Petition for Writ of Certiorari was filed on September 24, 1990 and granted, as to the question presented for review, demand futility, on December 3, 1990. Certiorari was denied on the second question, the right to jury trial. (A cross-petition, filed on October 19, 1990, was also denied on December 3, 1990). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

Section 20(a) of the Investment Company Act of 1940, as amended, 15 U.S.C. § 80a-20(a), is set forth at 96a.[1] Rule 23.1 of the Federal Rules of Civil Procedure is set forth at 99a-100a. SEC Rules 20a-1(a) and 20a-2(b)(4), 17 CFR §§ 270.20a-1(a) and 270.20a-2(b)(4) provide as follows:

[1] "___a" refers to the Appendix to the Petition for Certiorari. "J.A. ___" refers to the Joint Appendix.

Rule 20a-1. Solicitation of Proxies, Consents and Authorizations.

(a) No person shall solicit or permit the use of his name to solicit any proxy, consent or authorization in respect of any security of which a registered investment company is the issuer, except upon compliance with Rules 20a-2 and 20a-3 and all rules and regulations adopted pursuant to Section 14(a) of the Securities Exchange Act of 1934 that would be applicable to such solicitation if it were made in respect of a security registered on a national securities exchange. Unless the solicitation is made in respect of a security registered on a national securities exchange, none of the soliciting material need be filed with such exchange.

* * *

Rule 20a-2. Information Pertaining to Investment Adviser and Investment Advisory Contracts.

* * *

(b) If action is to be taken with respect to an investment advisory contract, the following information shall be included in the proxy statement:

* * *

(4) If the investment adviser acts as such with respect to any other investment company, identify and state the size of each such other company and state the rate of the investment adviser's compensation.

STATEMENT OF THE CASE

Petitioner is a shareholder of defendant Cash Equivalent Fund, Inc. (the "Fund"), an open-end investment company or mutual fund registered under the Investment

Company Act of 1940. She has brought the action on behalf of the Fund against Kemper Financial Services, Inc., its investment adviser (the "Adviser").[2]

The action is brought under Sections 20(a) and 36(b) of the Investment Company Act. Section 20(a) proscribes the fraudulent solicitation of proxies with respect to a registered investment company. The complaint herein alleges that the defendant distributed a false and misleading proxy statement which misrepresented comparative fee rates in order to obtain shareholder approval of its agreement with the Fund. The plaintiff complains that the Adviser provides substantially the same services for a sister fund and charges the sister fund significantly less, whereas the proxy statement gives the false impression that the fee rates paid by the sister fund are as high or higher than those paid by the Fund. 89a-91a. The complaint seeks the payment of damages to the Fund resulting from the fraud. 93a.

Section 36(b), which mandates a fiduciary duty with respect to the receipt of compensation, is not implicated in the instant proceeding.

Plaintiff made no pre-suit demand upon the directors to institute or prosecute the action. The complaint sets forth the reasons for not making such a demand. Those reasons are as follows:

> (a) With respect to the claims asserted under Section 36(b) of the Act, no such demand is required.

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[2] *Kamen v. Kemper Financial Services, Inc.*, No. 85 C 4587 (N.D. Ill.). Jurisdiction of the District Court was invoked under Sections 36(b) and 44 of the Act, 15 U.S.C. Sections 80a-35(b) and 43, respectively.

(b) The "interested" directors have a personal financial interest adverse to the successful prosecution of the lawsuit, and the so-called "non-interested" directors are beholden to the Adviser; they receive aggregate remuneration of approximately $300,000 a year as directors of the Fund and other Funds managed by the Adviser.

(c) All of the directors voted to distribute the false proxy statement so that any suit brought to establish liability for the falsity of the statement would establish their own culpability and liability.

(d) The directors caused the Fund to oppose the action on substantive grounds.

In addition, the complaint alleges that the directors are under the control of the Adviser and that application of a demand requirement would be inconsistent with the federal policy underlying Section 20 of the Investment Company Act. 92a-93a. In deposition testimony, the directors testified that they would not institute this action. J.A. 70-85. In short, as alleged in the complaint, making a demand on the Fund or its directors to institute or prosecute this action would be futile.

Defendants moved to dismiss plaintiff's claim of proxy fraud, and the District Court granted the motion on the ground that plaintiff had failed to justify the absence of demand upon the Fund directors to institute suit to recover for that claim. 33a, 46a-56a. Thereafter, the District Court dismissed the Section 36(b) claim, giving rise to a final judgment. 84a.

Upon appeal, the Court of Appeals reinstated the Section 36(b) claim, but affirmed the dismissal of the

proxy fraud claim, holding that demand on directors must be made even if it be futile.[3] 1a-32a.

SUMMARY OF ARGUMENT

The Court of Appeals' holding that demand must be made even if futile is contrary to long established legal principles and to the dictates of common sense. The holding below violates both state and federal law, is inconsistent with the public policy underlying the proxy fraud provisions of the Investment Company Act, and, if permitted to stand, would spell the demise of shareholder derivative actions which have been the most effective remedy against management overreaching.

Shareholder demand in the instant case is clearly futile and unwarranted. The directors are the very perpetrators of the proxy fraud complained of. They have voiced their opposition to the suit both in deposition testimony and by causing the Fund to oppose the action on the merits. Both the management directors and the so-called non-interested directors benefitted from the fraud, the former through higher fee payments and the latter through sizable emoluments derived from their office. Under these circumstances, requiring a demand would result in the destruction of a meritorious action.

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[3] Both the District Court and the Court of Appeals held that plaintiff was not entitled to a jury trial under Section 36(b). Because both courts held that the proxy fraud claim would not lie, neither court considered whether plaintiff is entitled to a jury trial thereunder.

ARGUMENT

I.

DEMAND ON DIRECTORS IS EXCUSED WHEN IT WOULD BE FUTILE

Although orderly presentation would normally call for our discussion to begin with an inquiry into the question of what law applies, the uniformity of judicial decisions and the egregiousness of the Court of Appeals' error prompts petitioner to begin with a brief discussion of the substantive issue involved.

To begin with, Rule 23.1 of the Federal Rules of Civil Procedure, which is a distillation of this Court's holdings[4], acknowledges the existence of exceptions to the demand requirement by permitting the plaintiff to allege the reasons for not making a demand. This Court held in *Smith v. Sperling*, 354 U.S. 91, 94 and n.2 (1957), that demand futility is just such an exception. Futility of demand satisfies the requirements of the rule. *Accord: Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984); *Delaware & Hudson Co. v. Albany & Susquehanna R. Co.*, 213 U.S. 435 (1909); *Doctor v. Harrington*, 196 U.S. 579 (1905)[5]; *Hawes v. Oakland*, 104 U.S. 450 (1881).

Following the holdings of this Court, the vast majority of Circuits – indeed, every Circuit Court of Appeals which has ruled upon the issue – has held that demand is excused where it would be futile. Illustrative of the cases

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[4] *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984).

[5] The Court of Appeals' attempts to distinguish *Fox*, *Delaware & Hudson* and *Doctor* will not withstand analysis. See pp. 6-8 of the Petition for Certiorari.

are the following: *Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59 (D.C. Cir. 1988); *Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22 (1st Cir. 1978); *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980); *Lewis v. Curtis*, 671 F.2d 779 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982); *Meltzer v. Atlantic Research Corp.*, 330 F.2d 946 (4th Cir.), *cert. denied, sub nom., Scurlock v. Meltzer*, 379 U.S. 841 (1964); *Clark v. Lomas & Nettleton Financial Corp.*, 625 F.2d 49 (5th Cir. 1980), *cert. denied*, 450 U.S. 1029 (1981); *Allright Missouri, Inc. v. Billeter*, 829 F.2d 631 (8th Cir. 1987); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204 (9th Cir. 1980). In addition, District Courts in the Sixth, Tenth and Eleventh Circuits have similarly held: *Granada Investments, Inc. v. DWG Corp.*, 717 F. Supp. 533 (N.D. Ohio 1989); *Mullen v. Sweetwater Development Corp.*, 619 F. Supp. 809 (D.C. Colo. 1985); *First American Bank and Trust v. Frogel*, 726 F. Supp. 1292 (S.D. Fla. 1989). And prior decisions of the Court of Appeals for the Seventh Circuit also held that demand is excused where futile: *Thornton v. Evans*, 692 F.2d 1064 (7th Cir. 1982); *Nussbacher v. Continental Illinois National Bank*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976).

In addition, virtually every state court passing upon the issue has also held that futility excuses demand. *See* 13 Fletcher, *Cyclopedia of the Law of Private Corporations* § 5965 and cases cited at note 1 thereof (1984 Rev. Volume and 1990 Cum. Supp.).

The court below did not cite any authority for its unique holding that futility does not excuse demand. It did lean heavily on the American Law Institute Tentative Draft, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03 (Tentative Draft No. 8, 1988). 13a,

14a, 15a, 16a. However, the Tentative Draft is clear on the existing state of the law. The very section cited by the Court of Appeals states, "Under prevailing law, demand on the board is required as a pre-condition to maintaining a derivative suit, unless such demand would be futile." (Tentative Draft, p. 64).

II.

WELL PLEADED FEDERAL PROXY FRAUD CLAIMS ARE NOT SUBJECT TO SUMMARY DISMISSAL UNDER STATE LAW

Burks v. Lasker, 441 U.S. 471 (1979), appears to be the starting point for determination of which law is applicable. *Burks v. Lasker* dealt with the question of whether disinterested directors of an investment company may terminate a shareholder's derivative suit brought against other directors under the Investment Company Act and the Investment Advisers Act. This Court held that "Federal courts should apply state law governing the authority of independent directors to discontinue derivative suits to the extent such law is consistent with the policies of the ICA and IAA." 441 U.S. at 486.

Although the question of directorial termination is closely related to the question of demand, this Court has indicated that *Burks v. Lasker* is not necessarily determinative in the latter situation. In *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532 n.8 (1984), the Court specifically referred to *Burks v. Lasker* and the holding therein that the substantive law of the state of incorporation applies to directorial termination. The Court continued, however, as follows:

> Because we conclude that a suit brought under § 36(b) of the ICA is not a "derivative action" for purposes of Rule 23.1, see *infra*, at 842, we need not decide whether the Rule itself, as a matter of federal procedure, makes demand on directors the predicate to a proper derivative suit in federal courts or whether any such obligation must instead be found in applicable substantive law.

Burks v. Lasker did not involve proxy fraud. SEC Rule 20a-2(b)(4) requires a proxy statement submitted in connection with a shareholder vote on an investment advisory contract to identify other investment companies for which the adviser acts and to state the rate of advisory compensation charged to such other companies. The manifest purpose of the regulation is to give the shareholders a basis for comparison. Here, however, the shareholders were led to believe by a false proxy statement that a sister fund was being charged as much or more than the Fund, whereas in fact the sister fund was charged considerably less. The difference amounted to $10,000,000 per year. 86a, 90a. The shareholders' approval of the advisory fees benefitted both the respondent, which was the direct recipient thereof, and the "non-interested" directors, whose sizable emoluments depended upon respondent's grace. 92a.

In *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980), a case subsequent to *Burks v. Lasker* but preceding *Fox*, the Court of Appeals for the Second Circuit, relying upon this Court's seminal decision in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), held that claims under the proxy laws were not subject to dismissal under the business judgment rule. Referring to Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a), the Court concluded (615 F.2d at 64):

> In short, we conclude that to the extent that a complaint states claims against directors under § 14(a) upon which relief may be granted, federal policy prevents the summary dismissal of those claims pursuant to the business judgment of those defendant directors.
>
> The conclusion that well pleaded § 14(a) claims against directors are not subject to summary dismissal on the basis of their exercise of business judgment makes unnecessary further study of what powers Ohio law would grant with respect to the § 14(a) claims.

Although in the present case the directors are not themselves defendants, they are the ones who distributed the proxy statement and are, therefore, directly responsible for the violation. 92a-93a. As the complaint alleges, the action, if successful, would establish their culpability. Just as a plaintiff may not bootstrap his futility assertions by naming innocent directors as defendants, *Lewis v. Graves*, 701 F.2d 245, 249 (2d Cir. 1983), by the same token, petitioner Kamen's choice not to name the directors in the first instance does not establish their impartiality. *Lewis v. Curtis*, 671 F.2d 779, 786-7 (3d Cir. 1982), *cert. denied*, 459 U.S. 880. Accordingly, under *Galef*, state law cannot justify dismissal of the present action.

While *Galef* relied upon the strong public policy declarations in *Borak* ("Private enforcement of the proxy rules provides a necessary supplement to commission action. [377 U.S. at 432][6] . . . the overriding federal law applicable here would, where the facts required, control

[6] This policy was expressly and strongly reaffirmed in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985).

the appropriateness of redress despite the provisions of state corporation law . . . " 377 U.S. at 434), other cases dealing with directorial terminations of actions involving asserted false proxy statements have applied state law. *E.g., Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), *cert. denied*, 449 U.S. 869 (1980). This brief will discuss both federal and Maryland law.

III.

UNDER MARYLAND LAW, DEMAND IS EXCUSED

In the present case, the Fund was a Maryland corporation when the action was commenced. 9a. The leading Maryland case is *Parish v. Maryland & Virginia Milk Producers Association*, 250 Md. 24, 242 A.2d 512 (1968), *cert. denied*, 404 U.S. 940 (1971). That case held that where the directors were involved in the wrongdoing, as they were here by sending out the false proxy statement, demand upon them to bring the action is properly excused. *Parish* also held that demand was excused because the directors affirmed their support of management's action after the commencement of the law suit. 242 A.2d at 546-47.

To similar effect in applying Maryland law is *Rosengarten v. Buckley*, 565 F. Supp. 193, 197-8 (D. Md. 1982), which holds that under Maryland law, fraud, such as the proxy fraud involved here, vitiates the demand requirement. *See also Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984), citing *Eisler v. Eastern States Corp.*, 182 Md. 329, 333 (1943), and *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978). In the last cited case, the Court, applying Maryland law, concluded (77 F.R.D. at 740):

> Accordingly, given plaintiff's allegations that all of the trustees either actively participated in the wrongful transactions or, at the least, approved or ratified such transactions with knowledge or notice of their illegality, the court concludes that demand upon the trustees to bring this action should be excused.
>
> . . . the conduct of the unaffiliated trustees in this action, which conclusively demonstrates their antagonism to it. ANRET's answer did not take a neutral position. Nor did ANRET merely oppose this action on the basis of lack of demand on the trustees or its shareholders. Rather, ANRET has vigorously opposed this action on the merits. In this regard, there is also authority that a demand upon directors or trustees is unnecessary where the derivative entity contests the action on the merits. *See, e.g., Meltzer v. Atlantic Research Corp.*, 330 F.2d 946, 948 (4th Cir.), *cert. denied sub nom., Scurlock v. Meltzer*, 379 U.S. 841, 85 S.Ct. 78, 13 L.Ed.2d 47 (1964).

As in *Oldfield*, the directors in the present case have caused the corporation to oppose the action on the merits. 93a; J.A. 2, 4, 6, 7, 24-25, 62, 65-66. In deposition testimony, their hostility to the action is manifest. J.A. 70-85. In short, under Maryland law, demand is clearly excused in the circumstances prevailing here.

The Court of Appeals refused to apply Maryland law because petitioner's urging of Maryland law was not made until the reply brief. Citing *Wilson v. O'Leary*, 895 F.2d 378, 384 (7th Cir. 1990), the Court held that the argument as to the application of Maryland law came too late. 9a. However, *O'Leary* was a criminal case in which the prosecution sought to argue for the first time in its

reply brief on appeal that an error in admitting an involuntary confession was harmless. As the Court stated, the reason for the requirement that arguments for reversal be made in the opening brief is "so that the appellee may address them." 895 F.2d at 384. In the present case, however, petitioner's reply brief in the Court of Appeals was filed on December 19, 1989. J.A. 2. Oral argument was not held until May 11, 1990 (J.A. 3), after an application by respondent for an adjournment of the date from April 12, 1990. In short, the respondent had ample time and opportunity to address petitioner's arguments as to Maryland law. The rigid application of a rule designed for the protection of criminal defendants should not operate to prevent the appropriate consideration of applicable law in the present circumstances, particularly in view of the fact that the court below adopted a rule of law not urged by any party prior to its decision. Moreover, in opposing certiorari, respondent discussed Maryland law. Respondent did not suggest that consideration of Maryland law was barred because of lateness, and thus, under Rule 15.1 of this Court, waived any such contention.

IV.

DEMAND IS EXCUSED UNDER FEDERAL LAW

As discussed under Point I, *supra*, the holding of the Court of Appeals that demand must be made even if futile is a conscious defiance of this court's prior holdings, as well as of the holdings of every federal court which has considered the question. One might assume that no court, much less a federal court of appeals, would issue such a doctrinaire opinion if it could reach the same result by a less revolutionary route. In this case the less

rebellious path would have been to rule that demand would not have been futile. But the postulated assumption is correct; such a finding would not be supportable.

What are the ingredients of futility? Obviously, a corporation's business is supposed to be run by its directors, and they are the first resort of policy decisions such as instituting litigation. But clearly there are considerations which lead to exceptions. *Hawes v. Oakland*, 104 U.S. 450 (1881), was the first[7] attempt to delineate the underlying considerations, but the Court there said little more than that the complaining shareholder should state with particularity why it was not reasonable to require him to exhaust his intra-corporate remedies. *Doctor v. Harrington*, 196 U.S. 579 (1905), set forth one example of futility. The Court there held that an allegation that the board of directors was controlled and dominated by the majority shareholder, whose self-dealing was attacked in the complaint, was sufficient to justify maintenance of a stockholder suit. *Delaware & Hudson Co. v. Albany & Susquehanna R. Co.*, 213 U.S. 435 (1909), extended the futility exception to a case involving interlocking directors, where, absent the majority control present in *Doctor*, there

[7] In *Dodge v. Woolsey*, 18 How. (59 U.S.) 331 (1855), a demand had been made upon the directors to sue to prevent the collection of a tax. The directors refused because they believed litigation would be cumbersome. The Court noted that " . . . the refusal . . . was a non-performance of a confessed official obligation, amounting to what the law considers a breach of trust, though it may not involve intentional moral delinquency." 18 How. at 345. The Court held that the shareholders could properly sue on behalf of the corporation: " . . . the powers of a court of equity may be put in motion at the instance of a single shareholder . . . ". 18 How. at 343.

was "practically efficient" control. 213 U.S. at 452. The Court held that demand was excused, stating (213 U.S. at 451):

> The company whose interest it was to assert the right to payment and to demand it was under the control or could be influenced by the company whose interest it was to deny indebtedness and resist payment. And though there are allegations in the bill of contrary import, the good faith of the directors need not be questioned. They might, notwithstanding, be firm in their views, – firm to resist appeals against them. Their views seemed to persist through many years. At any rate, a situation was presented fully as formidable to the interest of stockholders in the Susquehanna Company as that presented in the Harrington Case. And it may be well doubted whether the directors of the Susquehanna Company, so being directors of the Delaware Company, and who, either from an apathy that endured through many years, could discern no right in that company to assert, or, through conviction of the absence of right, were the best agents to begin or conduct a litigation of such right. It was certainly natural enough that a stockholder should seek more earnest representatives, and consider that the directors "occupied," to use the language of Dodge v. Woolsey, "antagonistic grounds in respect to the controversy" as to him. The attitude of the directors need not be sinister. It may be sincere. It was so in Chicago v. Mills, 204 U.S. 321, 51 L.ed. 504, 27 Sup.Ct. Rep. 286, and Ex Parte Young, 209 U.S. 123, 52 L.ed. 714, 13 L.R.A.(N.S.) 932, 28 Sup.Ct. Rep. 441, and other cases. In this case it was certainly determined. It continued until after this suit was brought. Both the Delaware Company and the Susquehanna Company, then under "the administration of the Delaware

Company," to quote from the circuit court of appeals, demurred to the bill.

In *Smith v. Sperling*, 354 U.S. 91 (1957), the Court expanded somewhat upon the definition of futility (354 U.S. at 96-97):

> It seems to us that the proper course is not to try out the issues presented by the charges of wrongdoing but to determine the issue of antagonism on the face of the pleadings and by the nature of the controversy. The bill and answer normally determine whether the management is antagonistic to the stockholders, as Central R. Co. of New Jersey v. Mills, 113 U.S. 249, 5 S.Ct. 456, 28 L.Ed. 949, and Doctor v. Harrington, supra, indicate. The management may refuse or fail to act for any number of reasons. Fraud may be one; the reluctance to take action against a close business associate may be another; honest belief in the wisdom of the course of action which the management has approved may be still another; and so on. As the Court said in Delaware & Hudson Co. v. Albany & S.R. Co., 213 U.S. 435, 451, 29 S.Ct. 540, 545, 53 L.Ed. 862, where the management was deemed to be antagonistic to the stockholder, "The attitude of the directors need not be sinister. It may be sincere." Whenever the management refuses to take action to undo a business transaction or whenever, as in this case, it so solidly approves it that any demand to rescind would be futile, antagonism is evident.

(footnote omitted). Justice Frankfurter, dissenting from the jurisdictional holding, agreed that "sincere opposition by directors would make such a demand [on the directors] futile" for purposes of compliance with Rule 94 (now Rule 23.1). 354 U.S. 99, 110 (1957). Justices Burton,

Harlan and Whittaker joined in Justice Frankfurter's opinion. The Court was, thus, unanimous on this point.[8]

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[8] In accordance with the decisions of this Court, the Seventh Circuit had earlier held that board opposition, including post-litem board opposition, is sufficient to excuse demand. In *Nussbacher v. Continental Illinois National B&T Co.*, 518 F.2d 873 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976), the court held that the post litigative decision by directors not to initiate action was sufficient to demonstrate the futility of demand. The court stated (at 878-79):

> Turning then to the issue which is before us, we are satisfied that there was sufficient before the district court to preclude it in the exercise of proper discretion from dismissing the case on the 23.1 ground. Upon analysis, it appears to us that Continental is contending in effect that demand had to be made. This position would make the alternative prong of Rule 23.1 which permits the plaintiff to explain why he made no demand about as meaningless as it would have been for plaintiff to have made a demand in the present case. Not only did the board of directors adopt the position at a meeting that they would not have initiated the New York action, identical in practically all respects to the suit filed in Illinois, but the affidavit of the board chairman which was before the district court concluded by referring to "the determination of the Board of Directors of Leasco Corporation that [the Illinois action] maintained by Plaintiff Nussbacher is inconsistent with the best interests of the Corporation." This decision and determination may well be proved to have been a sound evaluation when the merits questions are reached in this litigation; suffice it to say, the message is loud and clear that under no circumstances would the board of directors have approved the corporation bringing the action.

Dealing with another portion of Rule 23.1 (then Rule 23(b)), this Court said in *Surowitz v. Hilton Hotels Corporation*, 383 U.S. 363, 371, 373 (1966), "Rule 23(b) was not written in order to bar derivative suits. . . . We cannot construe Rule 23 or any other one of the Federal Rules as compelling courts to summarily dismiss, without any answer or argument at all, cases like this where grave charges of fraud are shown by the record to be based on reasonable beliefs growing out of careful investigation. The basic purpose of the Federal Rules is to administer justice through fair trials, not through summary dismissals as necessary as they may be on occasion. These rules were designed in large part to get away from some of the old procedural booby traps which common-law pleaders could set to prevent unsophisticated litigants from ever having their day in court. If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. Rule 23(b), like the other civil rules, was written to further, not defeat the ends of justice."

In the present case the record establishes the futility of demand. The case should proceed to an adjudication on the merits.

V.

REQUIRING DEMAND WHERE FUTILE POSES VIRTUALLY INSUPERABLE OBSTACLES TO THE ENFORCEMENT OF FEDERAL RIGHTS WITHOUT CONCOMITANT BENEFITS

The Court below engaged in a quasi-functional analysis of the law of demand, purporting to balance benefits

and burdens. Petitioner submits that the discipline of legal scholarship should govern the determination of cases and controversies. Nevertheless, if a functional analysis is applied, the conclusion to which one is compelled is that requiring demand even where futile results in the imposition of tremendous impediments to the enforcement of the securities laws, with the concomitant loss of investor protection which those laws are designed to achieve, while at the same time reducing rather than improving managerial efficiency.

The keystone of the analysis of the Court of Appeals is that the making of a demand is a "cheap and quick expedient", 15a, to which corporate directors will promptly and openly respond. The court below says "let the investor make [a demand]; if indeed futile, the board's response will establish that soon enough." 15a. "If demand is futile in fact for any of these reasons, then the board will say no with dispatch and the case may proceed." 17a. This naive hypothesis of the reaction of corporate directors accused of wrongdoing is totally at odds with reality. The court below admits that in those jurisdictions most insistent upon demand, notably Delaware, "tendering a demand to the board puts the plaintiff out of court". 12a.[9] It does so both procedurally – by

[9] *Kaplan v. Wyatt*, 484 A.2d 501 (Del.Ch. 1984), *aff'd*, 499 A.2d 1184 (1985), is illustrative not only of the obstacles confronting the plaintiff, but also of the burdens imposed upon the litigants and the judicial system when a demand is insisted upon. In that case, following the commencement of the litigation, the corporation on whose behalf it was brought proceeded to appoint a special litigation committee to investigate

(Continued on following page)

turning over litigation to special litigation committees – and substantively, by altering the applicable standard of conduct and the focus of its judgment.

(Continued from previous page)

and make a recommendation as to the complaint and its allegations. The committee hired special counsel who consumed three years with their investigation for which they billed the corporation $500,000. In the meantime, the plaintiff's discovery was limited to inquiries into the good faith and independence of the committee without inquiring into the merits of the litigation. The chancellor, who felt compelled to follow this procedure by the decision of the Delaware Supreme Court in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981), nevertheless voiced his misgivings with the entire procedure as follows:

> [I]t must be kept in mind that the entire procedure is designed to provide a means, if warranted, to throw a derivative plaintiff out of Court before he has an opportunity to engage in any discovery whatever in support of the merits of his cause of action purportedly brought on the corporation's behalf. In fact, the *Zapata* procedure takes the case away from the plaintiff, turns his allegations over to special agents appointed on behalf of the corporation for the purpose of making an informal, internal investigation of his charges, and places the plaintiff on the defensive once a motion to dismiss is filed by the Special Litigation Committee, leaving him to snipe away at the bona fides of the Committee and its extra-judicial investigation in a last-ditch effort to salvage a right to present the case on the corporation's behalf as he sees it. The procedure also asks the Court to consider dismissing the case prior to the time that the facts pertaining to the plaintiff's allegations are developed in an adversarial context unlike the procedure that has existed heretofore.

(Continued on following page)

The court below asserts that insistence upon a demand requirement will "not affect the standard with which the court will assess the board's decision not to sue." 13a. But, of course, it will, as the court itself admits (16a): "A decision not to file a weak lawsuit would be protected by the business judgment rule . . . ". In short, what the Court of Appeals is advocating is that cases involving self-dealing (*i.e.*, virtually all derivative cases), which require the imposition of fiduciary duty standards, be transformed into cases invoking the business judgment rule. Under the latter, conduct (presumed to be disinterested) cannot be attacked unless it be such that no reasonable business person would engage in it. On the other hand, a fiduciary involved in self-dealing has the burden of proving the intrinsic fairness of his dealings with the corporation. Moreover, the conduct upon which the judgment is focused becomes not the underlying wrongdoing – in this case the proxy fraud – but the inevitable decision not to press suit.

Little wonder is it then that commentators, including those relied upon by the court below, regard insistence upon demand, even where futile, as the death of the

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> As to whether this new departure in derivative litigation is good or bad I offer no judgment. . . . However, it is fraught with practical complications at the trial court level. It certainly does not speed up the course of derivative litigation and, based upon what I have seen so far, it is doubtful that it reduces the expense or inconvenience of derivative litigation to the corporation.

484 A.2d at 509-10.

derivative action; DeMott, *Shareholder Derivative Actions-Law and Practice*, § 5:03, p. 31 (1987): " . . . a derivative suit will not likely last long if the plaintiff files it after making a demand . . . ". Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 Nw. U. L. Rev. 96, 109 (1980):

> The special litigation committee cases may presage the demise of the derivative suit. When faced with a derivative suit, defendant directors will invariably request an investigation and decision by some fellow directors as to whether the suit is in the best interests of the corporation. The defendants have nothing to lose in so doing – at worst, the nonimplicated directors will decide to take over the suit, or to take a neutral stance toward the suit, leaving the defendants not worse off than when they started. More important, the prospect of such a decision is minimal; almost invariably, the directors charged with the decision decide to oppose the suit. In most cases, this opposition will result in dismissal of the suit unless the deciding directors are shown to be directly implicated in the alleged wrong or are so clumsy as to be found to have acted in bad faith. Such opposition can even block plaintiff's discovery as to defendants' alleged misdeeds.

(Footnotes omitted).

The decision of the Court below actively seeks to promote such a result by noting that, even when the action involves suit against some of the board of directors, "the board may appoint a minority of disinterested members to evaluate the demand and act for the corporation. In the extreme case in which all members are implicated, the board may expand its size and authorize the

new members to act for the firm." 15a. If this does not spell the death of all derivative actions, it certainly spells the death of derivative actions involving investment companies which, as this Court has noted, *Daily Income Fund v. Fox*, 464 U.S. 523, 538 (1984), are required to have at least 40% disinterested directors.

We began this point by noting the naivete of the Court of Appeals in assuming the ingenuous response of culpable directors in promptly and unambiguously refusing a demand. That human nature is not so pure is illustrated by the testimony of director David W. Belin in the instant case (J.A. 82-85):

> I have to be candid with you and tell you I don't think the litigation has any merit, but I was aware of it.
>
> Q. You've seen the complaint, I take it?
>
> A. I've sign [sic] the complaint. I've seen the – there is one clause that basically says, as I remember the complaint, something about having a misleading or insufficient information in the proxy statement concerning the Kemper Money Market Fund. I happen to believe that that is specious.
>
> But I understand that's not your opinion. That's my opinion. I've seen the complaint. With regard to – there is another portion that talks about the investment management fee being excessive. I believe and I think – I may be wrong by a few basis points, I think it's around 17 basis points or something and I think the fee is very reasonable particularly in light of the performance.
>
> So I just really basically disagree as a representative of the independent shareholders

that there is any merit, and I think for someone to say that it's misleading – because they refer to Kemper Money Market Fund. It says it has a top rate of 50 basis points and they should have given the whole complete gradation, I just think that's utterly without merit.

Q. So that if you had been asked directly to bring an action against KFS with respect to that claim, you would have refused, is that right?

MS. HALL: Hold your answer. I'm going to advise the witness not to answer that hypothetical question.

MR. MEYER: On what basis?

MS. HALL: On the basis that it's a hypothetical question. He's here to answer – not to answer hypothetical questions.

MR. MEYER: I take it you're following counsel's advice?

(WHEREUPON, discussion was had off the record between the witness and Ms. Hall out of the hearing of other counsel and the court reporter.)

MS. HALL: I'll withdraw my objection.

BY THE WITNESS:

A. I better have the question back then.

MR. MEYER: I notice that the withdrawal of the objection comes after conference between counsel and the witness.

MS. HALL: The record will reflect that I have consulted with my client.[10]

[10] Ms. Hall represents the respondent. Mr. Belin is, purportedly, an independent director.

MR. MEYER: Would you read the question back?

(WHEREUPON, the record was read by the reporter as requested.)

BY THE WITNESS:

A. Not necessarily.

BY MR. MEYER:

Q. Are you telling me there is a chance you would have brought such an action?

A. I'm telling you that right now, I would have to give it some consideration as to whether I would or wouldn't.

Q. Well, you've had the complaint for almost two years and you've come up with the conclusion that the contention is specious.

What consideration is it that you would want to give to such a request?

A. Well, I guess if someone said it – if someone came to me as a shareholder and said that they believed there was some merit, at least I would give it some consideration.

Q. Well, you know that Jill Kamen is a shareholder, don't you?

A. I believe she is. She claims she is.

Q. And she has advanced the claim. Why is it that your reaction to the complaint would be different than your reaction to an informal communication?

A. Well, I'm telling you at least right now what my considered opinion is, and you've said if someone – your questions basically – to go back to your specific question, saying I would automatically not do something. I guess I

> wouldn't automatically respond to it if that claim was brought up.
>
> That's why I said not necessarily. I still believe that based upon at least what I perceive to be the reasonable – well, I'll call the reasonable and prudent shareholder, that this lawsuit really does not have any merit.

The premise of the decision of the Court of Appeals is, in fact, that derivative lawsuits ought to be abolished. "In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors." Natural selection means that "Managers who make such judgment calls poorly ultimately give way to superior executives." 10a. The court below cites no empirical evidence supporting this conclusion, and, indeed, in the investment company field, the evidence is to the contrary. Both the SEC and the Congress, after extensive study, have found that investment company management is, if not impervious, at least not sensitive to competition.[11] Clearly even such competition as exists cannot operate effectively if corporations are permitted to deceive their shareholders with false proxy statements issued without fear of redress.

Although empirical, as opposed to intuitive, studies of the effectiveness of laws against heinous crimes may be difficult to pinpoint, one can hardly be complacent about the evisceration of an effective remedy against fraud. And that certainly is what the derivative suit is,

[11] S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969); Report of the SEC on the Public Policy Implications of Investment Company Growth, H. Rep. No. 2337, 89th Cong., 2d Sess. 12 (1966).

particularly in the context of proxy fraud. Professor Dent notes:

> Dean Rostow has called the derivative suit "the most important procedure the law has yet developed to police the internal affairs of corporations." Rostow, *To Whom and For What Ends Is Corporate Management Responsible?*, in The Corporation In Modern Society 48 (E. Mason ed. 1959). Justice Jackson called it "the chief regulator of corporate management." Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949). *See* Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966); Brendle v. Smith, 46 F. Supp. 522, 525-56 (S.D.N.Y. 1942); N. Lattin, The Law of Corporations § 115, at 457 (2d ed. 1971) ("The derivative suit is the minority shareholders' one effective remedy against management's abuse of its trusteeship.").

Dent, *The Power of Directors To Terminate Shareholder Litigation: The Death of the Derivative Suit?*, 75 Nw. U. L. Rev. 96 n.3 (1980).

Congress, fully cognizant of the importance of derivative actions in enforcing the securities laws, clearly "intended to preserve the pre-existing remedy" (*Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 379 (1982)) in its frequent amendments and re-enactments of those laws and, in particular, of the Investment Company Act. The Senate Committee on Banking, Housing and Urban Affairs stated: " . . . [P]rivate lawsuits serve as an added deterrent to conduct made unlawful by Congress without the necessity of governmental involvement. The Committee wishes to make clear . . . that such causes of action are implied under the Investment Company Act." S. Rep. No. 96-958, 96th Cong., 2d Sess. 14 (1980). *See also*

H. Rep. No. 96-1341, 96th Cong., 2d Sess. 29 (1980); *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982). The Court of Appeals decision, if allowed to stand, would thwart the expressed intent of Congress.

CONCLUSION

The decision of the Court of Appeals on the question presented for review should be reversed and the case should be remanded for further proceedings.

Respectfully submitted

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QUESTIONS PRESENTED

1. Whether the courts below correctly ruled that the allegations of petitioner's complaint were insufficient to excuse her failure to make a demand upon Cash Equivalent Fund, Inc. ("the Fund") before bringing this action, in which she alleges no fraud by the Fund's directors, seeks no relief against the Fund, and claims only that certain correct information included in a proxy statement distributed by the Fund created a "false impression" in connection with a comparison of fees charged by the Fund's investment adviser?

2. Whether, as a matter of federal common law and policy, the "futility" exception to the pre-suit demand requirement in federal shareholder derivative litigation should be abolished?

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

No. 90-516

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC. and CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

BRIEF FOR RESPONDENT CASH EQUIVALENT FUND, INC.

STATEMENT OF THE CASE

Petitioner Jill S. Kamen is a shareholder in respondent, Cash Equivalent Fund, Inc. (the "Fund"), a money market mutual fund registered as an investment company under the Investment Company Act of 1940, 15 U.S.C §§80a-1 *et seq.* (1981) ("the 1940 Act").* Respondent Kemper Financial Services, Inc. ("KFS"), is the Fund's investment adviser, manager and underwriter.

* Pursuant to Supreme Court Rule 29.1, respondent Cash Equivalent Fund, Inc. states that it has no parent or subsidiary company.

Petitioner's suit, a one-count action filed "on behalf of the Fund" in May, 1985, alleged that KFS and the Fund violated sections 20(a) and 36(b) of the 1940 Act, 15 U.S.C. §§80a-20(a), 80a-35(b). She asserted that KFS and the Fund sent shareholders a proxy statement that contained a single sentence which gave a "false impression" of the fees charged to the Fund. She also claimed that KFS had breached its fiduciary duty to the Fund by charging excessive fees for its advisory and management services.

Petitioner sought no relief against the Fund, nor did she join the Fund's directors as defendants. Petitioner made no particularized allegations of self-dealing or other wrongdoing against the Fund's directors, but claimed that pre-suit demand upon the Fund was excused on futility grounds.

Respondent KFS has set forth in its brief on this appeal a complete, concise and accurate statement of the parties' contentions and arguments in both lower courts that decided this case.

The Fund adopts respondent KFS's statement of the case on this appeal and, in deference to the Court, will not repeat it here.

SUMMARY OF THE ARGUMENT

The district court and the Seventh Circuit Court of Appeals each correctly concluded that petitioner's section 20(a) claim should be dismissed because she did not plead facts sufficient to excuse her failure to make pre-suit demand upon the Fund.

The district court, consistent with well-settled law, ruled that demand could be excused only where the complaint contained particularized allegations of director wrongdoing or self-interest. Petitioner's allegations of demand futility were thin indeed, and completely lacked the particularity

required under Rule 23.1, Fed. R. Civ. P., and a long line of established federal precedent. Both courts below correctly applied federal common law. However, petitioner's allegations of demand futility would likewise not meet the mark under Maryland law, which petitioner only lately argues should supply the substantive requirement of demand. Where, as in the instant case, petitioner's generalized and conclusory allegations were simply insufficient to make a showing that the directors could not act in a fair and impartial manner, the case should not proceed.

The Seventh Circuit agreed that the complaint, as finally amended, did not plead futility with the requisite particularity to survive respondents' Rule 23.1 challenge. The appeals court, however, found an additional and equally compelling reason to affirm. After a careful analysis of the rationale underlying the demand rule and its history from *Hawes v. Oakland*, 104 U.S. 450 (1881) to the present, the court noted that the futility exception to the demand rule in shareholder derivative litigation has generated a considerable body of litigation which has done little to advance the goals the rule was designed to achieve. It has sapped the rule of its energy by requiring litigants and the judiciary to speculate on fact-specific issues which customarily have little or nothing to do with the merits of the litigation. The demand rule has been transmogrified, by reason of its futility exception, from its genesis in federal common law as an exhaustion requirement, into a weapon by which dissident shareholders and their counsel seek to wrest management decisions from the directors to whom such decisions are properly entrusted. The Seventh Circuit correctly concluded that the exception had swallowed the rule, and should be removed from consideration in federal cases as a matter of federal common law.

It is now time to reinvest the demand rule with the vigor intended by this Court when it fashioned the requirement, recognizing, as the Seventh Circuit did, the evolution of methods and principles of modern business management. It also must be made clear that federal courts will enforce the demand requirement in federal rights cases, so that the precious resources of the courts will no longer be squandered in long and costly disputes before the merits of such cases are ever reached. The consequence of the evolutionary step taken by the Seventh Circuit will be to streamline shareholder derivative litigation.

Adoption of the demand requirement set forth by the Seventh Circuit will put the responsibility for corporate decision-making where it belongs in the first place, while enabling corporate shareholders and federal courts to concentrate their resources on the functions for which each is best suited.

As an *amicus* to these proceedings, the Securities and Exchange Commission ("SEC") seeks a reversal of the lower court decisions arguing that petitioner's claim is not derivative for purposes of Rule 23.1. This argument is not properly before this Court, inasmuch as petitioner has maintained throughout all phases of this litigation that her section 20(a) claim *is* derivative for purposes of Rule 23.1. Moreover, the effect of the ruling proposed by the SEC will be to prevent corporations from litigating important corporate rights.

ARGUMENT

Petitioner's allegations of director interest or involvement have twice been held insufficient to excuse pre-suit demand under federal law, initially by the district court (Pet. App. 50a-56a) and subsequently by the Seventh Circuit Court of

Appeals (Pet. App. 6a).[1] As an additional ground for dismissing petitioner's section 20(a) claim, the Seventh Circuit held as a matter of federal common law that allegations of futility could no longer excuse a shareholder's failure to bring pre-suit demand (Pet. App. 14a-15a). The district court's determination that petitioner failed to plead allegations of director interest sufficient to excuse demand is, and should be, dispositive of this appeal.

I. PETITIONER'S ALLEGATIONS OF FUTILITY FAIL TO EXCUSE DEMAND UNDER BOTH FEDERAL AND MARYLAND LAW

In light of the conclusory and unsupported nature of petitioner's allegations of futility, there is no basis for disturbing the district court's determination that they were insufficient to excuse demand. *See Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983) ("decision as to whether a plaintiff's allegations of futility are sufficient to excuse demand depends upon the particular facts of each case and lies within the discretion of the district court."); *Lewis v. Curtis*, 671 F.2d 779, 782 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982). For this reason, the Seventh Circuit's affirmance of

[1] Neither the district court nor the court of appeals considered the issue, belatedly raised by petitioner, of the impact of Maryland's demand futility rules on the resolution of this case. The district court did not consider this issue because petitioner did not present it. Indeed, petitioner's filings to the district court all suggested that federal law should apply. The Seventh Circuit did not consider the issue of Maryland law because petitioner did not mention it until her reply brief (Pet. App. 8a-9a), and even then, did not argue that Maryland law should in fact apply. Under these circumstances, petitioner has waived any right to raise the issue of Maryland law before this Court. *See McPhail v. Municipality of Culebra*, 598 F.2d 603, 607 (1st Cir. 1979).

the district court's decision on this ground should be upheld by this Court.

A. Petitioner's Allegations of Director Interest Are Insufficient Under Federal Precedent to Justify a Finding of Demand Futility

Generalized allegations of director interest, such as petitioners, which fail to raise even the slightest inference of bad faith or knowledge of illegal purpose on the part of the Fund's directors, have consistently been rejected by the federal ~~courts as~~ inadequate under Fed. R. Civ. P. 23.1. The district court correctly applied this unanimous federal law in its rejection of each of petitioner's individual allegations of director interest.

First, petitioner asserts in Paragraph 17(b) of her amended complaint (Pet. App. 92a) that futility is demonstrated by the fact that the seven "disinterested" directors receive remuneration for serving as directors of the Fund.[2] The fact of director remuneration does nothing to advance petitioner's argument in support of demand futility. If it did, the exception would swallow the requirement that demand generally be made. Indeed, petitioner's assertion, taken to its logical conclusion, would mandate a determination that

[2] Congress structured the 1940 Act to place the business affairs of investment companies in the hands of disinterested directors—*i.e.*, directors who are not "affiliated" with or "interested" in the investment company, its underwriters or legal counsel. *See* 15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a). Indeed, section 10(a) of the Act mandates that forty percent of an investment company's directors be disinterested as that term is defined by section 2(a)(19).

Seven of the Fund's ten-member board of directors are disinterested.

futility is established whenever any director who is paid for his services participates in a decision which subsequently becomes the subject of shareholder concern.[3] Rule 23.1 would be rendered ineffective by such a proposition.

In Paragraph 17(c) of her amended complaint (Pet. App. 92a-93a), petitioner states that demand futility is demonstrated in this case because the Fund's disinterested directors assisted KFS in the solicitation of the allegedly misleading proxy statement. As the district court aptly noted, however, "courts have consistently held that 'mere approval of challenged conduct is insufficient to render the demand futile.'" (Pet. App. 53a) (quoting *Lewis v. Anselmi*, 564 F. Supp. 768, 772 (S.D.N.Y. 1983)). *See also Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988) ("rare is the significant corporate act that has not been 'approved of' or 'acquiesced in' by the board of directors") and cases cited therein. In *Lewis*, 701 F.2d at 248, the First Circuit stated, "[t]he fact that a corporation's

[3] The *ad infinitum absurdum* nature of an argument similar to this was recently recognized by noted commentators in their discussion of the potential impact of the so-called "structural bias theory" on the ability of independent directors to impartially review the merits of derivative litigation. In *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law. 503, 534 (1989), Dooley and Veasey ask:

> If familiarity breeds acquiescence in litigation matters, will it not do so in other contexts as well. If so, does this not suggest a wholesale abandonment of the business judgment rule in favor of judicial review of every board approval of a management proposal that turns out badly?

By substituting "remuneration" for "familiarity" in the above-quoted passage, the absurdity of petitioner's allegation becomes apparent.

directors have previously approved transactions subsequently challenged in a derivative suit does not inevitably lead to the conclusion that those directors, bound by their fiduciary obligations to the corporation, will refuse to take up the suit." *See also Grossman v. Johnson*, 674 F.2d 115, 124 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982). The recognition of this fact of corporate life has prompted most federal courts to require an additional showing of bad faith or approval with knowledge of illegal purpose. *See Gaubert*, 863 F.2d at 65; *Lewis*, 701 F.2d at 248 ("absent specific allegations of self-dealing or bias on the part of a majority of the board, mere approval and acquiescence are insufficient to render demand futile"); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980) ("'[w]here mere approval of a corporate action, absent self-interest or other indication of bias, is the sole basis for establishing the director's "wrongdoing" and hence for excusing demand on them, plaintiff's suit should ordinarily be dismissed.'") (quoting *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973)). Based on this precedent, petitioner's simple assertion that the Fund's directors participated in the solicitation of the proxy statement cannot independently support a finding of futility necessary to meet the requirements of Rule 23.1.

As the district court correctly noted (Pet. App. 54a), petitioner's allegations in Paragraphs 17(d) and (e) of her amended complaint (Pet. App. 93a) do not state any facts; rather, they simply make conclusory claims of control and domination. Rule 23.1 requires a shareholder plaintiff to allege "with particularity" the reasons for failure to obtain corporate action on the claim. This requirement of "particularity" has been vigorously enforced. *Grossman*, 674 F.2d at 123. *See also In re Kauffman*, 479 F.2d at 263 (recognizing that Rule 23.1 is an "exceptional rule of pleading, serving a special purpose"). Petitioner's conclusory allegations of control do not factually demonstrate how the Fund's three interested directors will control the decisions of a ten-member board. Such unsupported allegations of "control" are particularly insufficient in excusing demand in situations such as this where the affiliated directors are in the minority. *See In re Kauffman*, 479 F.2d at 264 ("[p]laintiff must allege specific facts demonstrating the unmistakable link between the unaffiliated majority and the affiliated and allegedly wrongdoing minority").

Paragraph 17(f) of petitioner's amended complaint (Pet. App. 93a) alleges that demand would be futile in this case because the Fund moved to dismiss the case on substantive grounds. In fact, the Fund joined KFS's motion to dismiss because petitioner failed to make a demand, and on the additional ground (unrelated to this appeal) that section 36(b) of the Act should be petitioner's exclusive remedy in an action alleging excessive advisor's fees. The Fund took no position concerning the merits of petitioner's proxy violation claim. Thus, the Fund's motion provides no indication that its directors would not have fairly and impartially considered a demand. Moreover, as the district court correctly noted, that which corporate directors do subsequent to the commencement of a derivative action is not important for purposes of ruling upon the issue of pre-suit demand futility. *See Grossman*, 674 F.2d at 123 ("'The futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight.'") (quoting *Cramer v. General Telephone & Electronics Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979)). Thus, the fact that the Fund joined KFS in motions to dismiss the complaint has no bearing on the ability of the Fund's directors to impartially review the merits of petitioner's cause of action.

Finally, petitioner alleges in paragraph 17(g) of her amended complaint (Pet. App. 93a) that demand would have been futile because an application of the demand rule to these circumstances would be inconsistent with the policy underlying section 20 of the 1940 Act (Pet. App. 94a). This allegation is completely without explication; not only does petitioner fail to specify the nature of the underlying policy of section 20(a), she gives no indication as to how a demand upon the Fund's directors in this case would jeopardize that policy. In the absence of any "particularity" to support her allegations in this regard, petitioner has failed to meet the pleading requirements of Rule 23.1.[4]

For all of these reasons, the decision of the lower court dismissing petitioner's amended complaint for failure to comply with the requirements of Rule 23.1 should be affirmed.

B. Petitioner Has Failed to Allege Director Involvement or Interest Sufficient to Excuse Demand Under a Principled Application of Maryland Law

Although not properly presented to either of the lower courts, petitioner contends in these proceedings that her allegations of director interest are sufficient under Maryland law to excuse her failure to make prior demand upon the Fund's directors. Petitioner has waived this argument. *See* footnote 1, *supra*. Moreover, even had this argument not been waived, it is without merit. Petitioner misunderstands

[4] In addition, it is not clear that the substance of this allegation, even if pleaded with particularity, would support a finding of futility. Determinations regarding demand futility focus on the independence and disinterestedness of the corporate directors. Petitioner's paragraph 17(g) fails to make any factual allegations of director interest or bias.

the precedent upon which she premises her argument by improperly attempting to extract "blackletter" principles from those cases while ignoring the underlying factual foundation which gave rise to their findings of demand futility.

The requirement of pre-suit demand upon corporate directors in Maryland, and its futility exception, is settled law. In *Parish v. Maryland & Virginia Milk Producers Ass'n.*, 242 A.2d 512, 544 (1968), *cert. denied*, 404 U.S. 940 (1971), the Maryland Court of Appeals stated:

> It is well established that ordinarily the courts will not entertain a derivative suit by a stockholder on behalf of a corporation until it appears that the intra-corporate remedies have been unsuccessfully pursued by the complaining stockholder. This means that, generally speaking, the complaining stockholder must make demand upon the corporation itself to commence the action, and show that this demand has been refused or ignored. This general rule, however, is subject to a well-recognized exception, i.e., that no such prior demand is required when it would be futile. Our predecessors in *Eisler v. Eastern States Corporation*, 182 Md. 329, 333, 35 A.2d 118, 119 (1943) cited 14 *C.J. Corporations* § 1339 as stating the general rule as follows:
>
> "Before a stockholder may sue the Corporation to enforce and protect its rights or to redress wrongs to it, he must first make an earnest and unsuccessful effort to obtain remedial action by the Corporation itself, first by application to the directors, and then by application to the body of the stockholders. But he need not do so where the circumstances are such that an application would be futile."

Like most state and federal jurisdictions, Maryland requires particularized allegations of misconduct which go to the independence and disinterestedness of the directors upon whom demand would be made to justify a finding of futility. The relevant issue is whether the directors were so involved in the alleged wrongdoing that they could not possibly act independently in prosecuting the derivative litigation. If there is no foundation upon which director interest or involvement can be premised, there is no reason to assume that the directors would be unable to independently review the merits of the shareholder's proposed claim, and consequently, no reason to excuse demand. Petitioner's claim that her allegations of director interest justify a finding of demand futility cheapens this foundational premise of Maryland's futility exception, as is apparent from a comparison of her allegations with those found sufficient in the cases upon which she relies.

In *Parish*, the Maryland Court of Appeals considered a shareholder derivative complaint which contained particularized allegations of fraud, concealment, illegality, gross negligence, waste of corporate assets, and conspiracy to conceal losses on the part of the majority of the directors who were named as defendants in that case. Based on these allegations of director involvement in illegal activity and the presumption of director antagonism which they raised, the Maryland Court not surprisingly concluded that the directors who participated in those illegal activities would not be able to act independently in reviewing the propriety of their own conduct. *Parish*, 242 A.2d at 545.

Likewise, in *Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984), the district court found demand excused where the complaint alleged that the company's directors actively participated in the wrongdoing by granting lucrative "golden parachute" contracts in order to perpetuate their

control over the corporation. In *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978), the court found demand excused under Maryland law where the plaintiff satisfactorily alleged that all trustees either actively participated in the wrongful transactions or ratified them with knowledge or notice of their illegality. Finally, in *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990), demand was excused where the complaint alleged that various of the directors had aided and abetted illegal activity, fraudulently overcharged the U.S. government, and permitted the company to illegally obtain U.S. Defense Department confidential information.

Petitioner's amended complaint describes no such director interest or involvement. Rather, she argues that demand should be excused because the Fund's directors sent out the allegedly "false" proxy statement (Pet. Br. 11).[5] There is no question that the Fund's directors did participate in the distribution of the proxy statement. Because this is alleged as an act of wrongdoing, however, it is instructive to note that petitioner has failed to present other facts which cast this participation in a "fraudulent" light. Certainly there are no allegations, particularized or otherwise, of affirmative wrongdoing—*i.e.*, wrongful conduct affirmatively undertaken for purposes of self-enrichment or protection. Nor are

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[5] In her brief to this Court, petitioner also characterizes her section 20(a) claim as "proxy fraud" (Pet. Br. at 11), a term conspicuously absent from her offerings in either court below. *Rosengarten v. Buckley*, 565 F. Supp. 193 (D. Md. 1982), which petitioner cites in support of her position, also wisely counsels that courts will look carefully to see if fraud is actually involved before demand will be excused. "Of course, a plaintiff may not escape the demand requirement by characterizing a suit which is really based on a breach of fiduciary duty as a fraud action." 565 F. Supp. at 198.

there any particularized allegations of fraud. *See Zimmerman, Oldfield, Burt, supra.*

In addition, petitioner alleges that demand futility has been shown because of the fact that the Fund's directors caused the Fund to oppose the action on the merits (Pet. Br. 12). There appear to be no reported cases applying Maryland law deciding whether *post-litem* director opposition is sufficient reason to excuse pre-suit demand. There is also no reason to believe that Maryland courts would not follow the overwhelming weight of authority rejecting such an argument. *See Grossman,* 674 F.2d at 123; *Cramer,* 582 F.2d at 276.

The fatal flaw in petitioner's argument is that she separates the holding of *Parish* from its underlying facts and, in so doing, strips that decision of its foundational premise. If the holding in *Parish* is to have any principled parameters—that is, if the court's decision in *Parish* is premised upon a discernable level of director self-interest which can be presumed from the allegations of wrongful director conduct—then the underlying facts of that case must be considered in reviewing the allegations of futility in other cases. Surely, the Maryland Court of Appeals did not intend its fact-based *Parish* decision to place corporate affairs in the hands of dissident shareholders and their counsel on the flimsy grounds pleaded in this case.

II. THE FUTILITY EXCEPTION TO THE DEMAND REQUIREMENT IN SHAREHOLDER DERIVATIVE LITIGATION PREMISED UPON FEDERAL QUESTION JURISDICTION SHOULD BE ABOLISHED

In addition to affirming the district court's judgment that petitioner failed to allege sufficient excuse for pre-suit demand, the Seventh Circuit reached the conclusion that

allegations of futility could not excuse a shareholder's failure to make a demand on a corporation's board prior to instituting derivative litigation in federal question cases. This determination, based on a thoughtful analysis of the role of demand in modern derivative litigation, should be affirmed by this Court.

A. The Seventh Circuit Properly Held that Federal Common Law Governs Issues Concerning the Necessity of Demand in Federal Question Cases

The foundation of the demand requirement in shareholder derivative litigation is firmly rooted in the federal common law. As originally envisioned by this Court in *Hawes v. Oakland,* 104 U.S. 450 (1881), pre-litigation shareholder demand upon a corporation's directors was an "exhaustion" requirement.[6] Based on this precedent and that of other federal courts, and commentators who have considered the issue, the Seventh Circuit rightly concluded that federal common law governs issues concerning the necessity and sufficiency of demand in federal question cases (Pet. App. 9a). *See* Wright, Miller and Kane, *Federal Practice and Procedure: Civil 2d* § 1831, p. 100 (1986) ("[f]ederal law governs the issue whether plaintiff has made sufficient demand on the directors."); *Sax v. World Wide Press, Inc.,* 809 F.2d 610, 613 (9th Cir. 1987); *Kaster v. Modification Systems, Inc.,* 731 F.2d 1014, 1017-18 (2d Cir. 1984); *Greenspun v. Del E. Webb Corp.,* 634 F.2d 1204, 1208-10 (9th Cir. 1980); *In re Kaufman Mutual Fund Actions,* 479

[6] This Court stated, "before the shareholder is permitted in his own name, to institute and conduct a litigation which usually belongs to the corporation, he should show . . . that he has *exhausted* all the means within his reach to obtain, within the corporation itself, the redress of his grievances. . . ." *Id.* at 462-63 (emphasis supplied).

F.2d 257, 263 (1st Cir. 1973). *See also Meltzer v. Atlantic Research Corp.*, 330 F.2d 946, 948 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964) ("[t]he necessity and sufficiency of the preliminary demand upon the directors, and the circumstance which satisfies omission of such demand under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law.").[7]

Both petitioner and the SEC contend that this Court's decision in *Burks v. Lasker*, 441 U.S. 471 (1979), mandates application of the various states' laws to the issue of demand futility, even when it arises in the federal courts in the context of federal question litigation (Pet. Br. 8-11; SEC Br. 16-19). Indeed, the SEC posits that state law should uniformly apply to issues surrounding the demand requirement because this is an area where "the States enjoy primary responsibility." (SEC Br. 16). This contention demonstrates a fundamental misperception of the premise underlying this Court's decision in *Burks* and the impact, or lack thereof,

[7] The requirement for pre-litigation demand originally set forth in *Hawes* has been engrafted into successive generations of federal rules, culminating with its present codification in Rule 23.1. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984). While uniformly enforced through the present day, it is not clear whether the demand requirement of Rule 23.1 is procedural, substantive or both. *See generally Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59, 63 and n.2 (D.C. Cir. 1988); *In re Consumers Power Company Derivative Litigation*, 111 F.R.D. 419, 423 (E.D. Mich. 1986) (in diversity cases demand is both procedural and substantive). This Court left that issue unresolved in *Fox*. 464 U.S. at 532 n.8. *But cf.*, 464 U.S. at 543-44 (Rule 23.1 is concerned solely with the adequacy of the pleadings and creates no substantive rights) (Stevens, J., concurring). Whether the rule is substantive or procedural, there can be no doubt as to its wisdom.

which that premise has on the issue of demand in federal courts.

In *Burks*, this Court was presented with the question of whether disinterested directors of an investment company had the power to terminate derivative litigation brought by a shareholder against other directors. The resolution of this issue required the Court to address questions which directly implicated an area of traditional state concern: the right of a board of directors to terminate litigation. Indeed, this Court described state law as "the font of corporate directors' powers." 441 U.S. at 478. Because of the states' interest in this issue, this Court resolved the issue presented in *Burks* by first referring to state law.

The recognition of the state interest which guided this Court's analysis in *Burks* does not impact the resolution of the issue presented today. In fact, the issue resolved by this Court in *Burks* is confronted only after the procedural demand hurdle has been cleared.[8] As originally conceived by this Court in *Hawes v. Oakland*, pre-litigation demand was an "exhaustion" requirement, a non-juridical station through which a shareholder must proceed before being permitted to pursue his litigation against the corporation. The fundamental concern of corporate governance upon which this Court premised its decision in *Burks*—whether the board of directors may terminate litigation—simply does

[8] This Court held in *Burks* that federal courts should apply state law when confronted with questions concerning "*the authority of independent directors to discontinue* derivative suits. . . ." 441 U.S. at 486 (emphasis added). Decisions to continue or discontinue derivative suits are one step removed from a shareholder's demand which simply raises the issue for directorial consideration. If a demand is made, such a decision may never be reached. *See* p. 22, *infra*.

not enter into the equation of whether or not demand should be required in a particular situation.

Only federal interests are implicated in issues concerning demand in federal courts. Foremost among those interests is a federal court's legitimate interest in efficiently and effectively structuring the proceedings which govern shareholder derivative litigation. The Seventh Circuit's abolition of the futility exception in federal question cases is no more than an attempt to achieve this legitimate federal interest.

B. The Evolution of the Federal Common Law in this Context Should Not Be Thwarted by Reference to Precedent Which Has Not Considered the Precise Issue Before this Court

Petitioner portrays the Seventh Circuit's decision as "revolutionary" and in conflict with the precedent of this Court and other federal courts. Yet she is unable to point to any decision of this Court or any other federal court which has directly addressed the issue of the continued viability of the futility exception.[9] It is true that the Seventh Circuit's forward-moving decision stands alone among federal decisions in its treatment of the futility exception. A decision which stands alone, however, is not necessarily unsupported as petitioner would have this Court believe. Indeed, within the context of an evolving federal common law, the truly evolutionary decision must always stand alone for at least a

[9] In *Johnson v. Hui*, 752 F. Supp. 909 (N.D. Cal. 1990), the District Court for the Northern District of California declined the opportunity to follow the lead of the Seventh Circuit in abandoning the futility exception in shareholder derivative litigation. The district court noted that Ninth Circuit precedent which governs its decisions still recognizes the futility exception in certain limited circumstances.

short while. If the evolution is warranted, other decisions soon follow in its footsteps. In this case, an examination of the policies supporting the Seventh Circuit's abolition of the futility exception, and the benefits to be derived from such an abolition, indicate that the Seventh Circuit's action is truly warranted.

C. Abandonment of the Futility Exception in Federal Derivative Litigation Promotes Judicial Efficiency in Resolving the Merits of Those Disputes While Fostering Other Forms of Intracorporate Dispute Resolution

Increased efficiency in the context of shareholder derivative litigation is achieved through the federal courts' ability to modify the common law surrounding the federal demand requirement in a manner which it deems best suited to achieving the desired result. The opinion of the Seventh Circuit in this case makes just such a modification. Specifically, the Seventh Circuit's abolition of the futility exception in federal derivative litigation reinvigorates the demand requirement by restoring its ability to achieve the salutary goals initially envisioned for it.[10] The rule is simple: share-

[10] A comprehensive summary of the purposes underlying the demand requirement in shareholder derivative litigation is found in *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D. Ill. 1981), wherein the court stated:

> The purpose of the demand requirement of Rule 23.1 is to allow a corporation to activate intracorporate remedies to address shareholder complaints prior to resorting to judicial intervention. . . . In theory, this salutary policy inures to the benefit of all involved. The dissident shareholder is provided with an opportunity to achieve his goal without incurring the expense of litigation; the directors of the corporation are allowed to occupy their status as managers of the corpora-

holders bringing derivative claims in federal court premised upon federal question jurisdiction must always make a prior demand upon the corporation's directors. The policies which support it are strong: judicial efficiency in resolving the disputes underlying derivative claims is increased and alternative forms of intracorporate dispute resolution are encouraged.

One recognized purpose of the demand requirement is that of limiting shareholder access to federal courts for redress of derivative claims.[11] The futility exception has stripped the demand requirement of its ability to fulfill this purpose. Indeed, the practical impact of the futility exception has been to swing the pendulum in the other direction: shareholders have greater access to federal courts, oftentimes on issues, such as the issue presently under discussion, which do not help resolve the merits of the underlying derivative claim.[12] The Seventh Circuit noted this fact when

> tion's affairs; the corporation is left to clean its own house, free from judicial entanglements; and the courts are relieved of the burden of prematurely resolving intracorporate disputes.

These purposes have been well-recognized by this Court and other federal courts for over a century. *See Hawes*, 104 U.S. at 461-62; *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532-33 (1984); *Lewis v. Graves*, 701 F.2d 245, 247 (2d Cir. 1983); *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

[11] In *Fox*, 464 U.S. at 531, this Court observed that the prerequisites to bringing derivative suits first announced in *Hawes* were intended, in part, "to maintain derivative suits as a limited exception to the usual rule that the proper party to bring a claim on behalf of the corporation is the corporation itself. . . ."

[12] Fundamental to the argument in support of a continued recognition of the futility exception is the presumption that directors who are "biased" in some way against shareholder-challenged conduct are unable to independently review the merits of the shareholder's proposed litigation. This presumption, when coupled with the disincentive to bring demand which is inherent in some jurisdictions' demand/futility rules, serves only to encourage shareholders to forego a prior demand and allege futility. *See Bach v. National Western Life Ins. Co.*, 810 F.2d 509, 513 (5th Cir. 1987) ("[t]he incentives of the Delaware rule are apparent: it discourages the making of demands and the delegation of investigative duties to the most independent directors."). Once futility is alleged, the threshold issue often becomes a fact-specific inquiry into the "bias" of the corporation's directors towards the shareholder's proposed litigation. The problem: neither of these predictable consequences of the futility exception advances the merits of the litigation or otherwise brings the parties together in some form of intracorporate dispute resolution.

it stated, "[i]t is easy to point to hundreds of cases, including this one, in which the demand requirement was itself the centerpiece of the litigation." (Pet. App. 9a).[13]

Under the Seventh Circuit's rule, a shareholder's derivative claim will be resolved in one of three ways: (1) the corporation and the shareholder may pursue alternative forms of intracorporate dispute resolution; (2) the corporation may choose to act on the shareholder's demand and pursue and control the proposed litigation; or (3) the corporate directors may recommend that the shareholder's de-

[13] Also cognizant of this problem, the American Law Institute ("ALI") has observed, "[t]he futility exception, while generally recognized, is nonetheless ambiguous in scope and has proven a prolific generator of litigation." *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03, comment a at 64 (Tent. Draft No. 8, 1988). The ALI goes on to state, "[w]hatever the standard used to state the futility exception, close questions are inevitable and consequent litigation predictable over the necessity of demand." *Id.*

mand be refused. Each of these scenarios achieves a more efficient resolution of the shareholder's derivative claim than is presently achieved under rules which excuse demand based on allegations of futility.

Pre-litigation demand which leads to alternative forms of intracorporate dispute resolution presents the best of all possible choices: the allegations underlying the shareholder's demand are addressed, the corporation and the shareholder are saved the time and treasure which would otherwise be spent in litigation, and the federal courts are relieved of the burden of needless litigation over hypothetical questions of "director bias" which necessarily accompany a shareholder's allegation of demand futility. Moreover, as noted by the court in *Gaubert*, 863 F.2d at 65, "the demand for relief may alert the board to problems of which it was unaware, and may cause it to champion the complainant's cause more directly, more efficiently and/or more effectively than the shareholder could have done alone. . . ."[14]

Likewise, if the corporation chooses to accept demand and pursue the litigation on its own behalf, the shareholder is substantially better off than if he had opted to allege demand futility. The litigation which results will focus directly upon the shareholder's allegations of wrongdoing rather than attempting to answer hypothetical questions

[14] This case presents a compelling example of a case which might have been quickly and easily resolved by a demand. Prior to petitioner's filing of her complaint, a number of options were available for intracorporate resolution of her dispute. Had the Fund's directors been made aware of Kamen's claim at the time she was contemplating her lawsuit, the Fund's directors might have taken action to satisfy her. Unfortunately, petitioner's haste to the courthouse precluded the directors from being able to respond to petitioner's complaint in a non-litigious manner.

about the ambiguous concept of demand futility. Indeed, even in those situations where the corporation opts to refuse demand, requiring the shareholder to make demand in the first instance promotes judicial efficiency in the resolution of the merits of the derivative claim by avoiding the need for peripheral litigation over the issue of demand futility. In a situation such as this, where demand is alleged to be excused, substantial resources have been consumed in litigation on the collateral issue of futility, without ever making strides towards the actual merits of the dispute. The same will not be true under a uniform federal rule which requires demand in all instances—*i.e.*, if futility is never an excuse, the focus of the litigation begins and ends with the merits of the underlying dispute.[15]

The Seventh Circuit stated, "[i]f demand is useful, then let the investor make one; if indeed futile, the board's response will establish that soon enough. In either case, the litigation may proceed free of arguments about whether a demand should have been made in the first place." (Pet. App. 15a). Petitioner thinks such an approach naive (Pet. Br. 19). The benefits to be derived from this approach and the sound jurisprudential policies which support it demonstrate otherwise.

D. The Rule of Demand Adopted by the Seventh Circuit will Present No Impediment to the Proper Resolution of Derivative Claims.

Contrary to petitioner's assertions, the adoption of a uniform rule requiring demand in all circumstances in

[15] Like the SEC (SEC Br. 29 n.23) and KFS (KFS Br. 23 n.15), the Fund submits that this case does not present the proper vehicle for determining what standard of review should be applied once a demand has been made and declined.

federal cases will neither spell the death of derivative litigation, nor present "insuperable obstacles to the enforcement of federal rights" (Pet. Br. 18). Rather, the requirement of demand advanced by the Seventh Circuit will place the responsibility for corporate decision-making where it belongs in the first place, while at the same time enabling corporations and federal courts to concentrate their respective resources on the functions for which each is best suited.[16]

Petitioner's gloomy forecast is premised upon a fundamentally faulty assumption that the adoption of such a requirement in federal jurisprudence necessarily entails a deferential standard of review for determining the reasonableness of a board's failure to bring suit. The fatal flaw of this assumption is that it ignores the underpinnings of the decision upon which it is based. Under the demand requirement adopted by the Seventh Circuit, the making of a demand is not in any way linked to the standard of review which may subsequently be applied to a board's decision not to sue. The court expressly stated, "when the demand

[16] The First Circuit recognized as much when it stated, "[a]fter a demand provides them with 'full knowledge for the basis for the claim,' (citation omitted), *it is for the directors*, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' *to decide the appropriate corporate response*." *In re Kauffman Mutual Fund Actions*, 479 F.2d at 266-67 (citation omitted) (emphasis supplied). As the Seventh Circuit aptly noted, "[c]hoosing between litigation and some other response may be difficult, depending on information unavailable to the courts and a sense of the situation in which business executives are trained. Managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism 'selects out' judges who try to make business decisions." (Pet. App. 10a).

requirement comes from federal common law, the making of a demand does not affect the standard of review with which the court will assess the board's decision not to sue." (Pet. App. 13a).[17]

Moreover, while complaining of a veritable nightmare of "insuperable obstacles" and "tremendous impediments" which she claims will result from the demand rule adopted by the Seventh Circuit, petitioner cites but one Delaware case in support of her argument. In *Kaplan v. Wyatt*, 484 A.2d 501 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (1985), the Delaware Supreme Court affirmed a trial court decision dismissing a derivative case on the recommendation of a special litigation committee that conducted an exhaustive investigation of the claims after suit was filed. The case turned on whether the lower court correctly applied the two-step analysis described in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981). *Kaplan* did not decide an issue of pre-suit demand, and it does not support petitioner's argument.

First, the issue in *Kaplan* was whether the lower court determined and applied the proper standard of review—an issue not reached in the Seventh Circuit's analysis. Second, petitioner seems to complain that the *Kaplan* investigation was too long, too costly, and too thorough. Here again, she has missed the point. An investigation will be conducted, either at the corporation's expense prior to suit or at everyone's expense (including the court's) after suit is filed. Pre-suit demand is the issue in this case, and petitioner has made no showing of any meaningful obstacle or impediment

[17] This severance of the link between the making of demand and the applicable standard of judicial review comports with the ALI's judgment that "the need for demand and the standard of judicial review are logically distinct." *Principles of Corporate Governance*, § 7.03, comment a at 65 (Tent. Draft No. 8, 1988).

to a valid claim by a minority shareholder under the demand rule adopted by the Seventh Circuit.

Petitioner concludes by quoting a passage from Fund director David Belin's deposition. The key element of this independent director's testimony was that if petitioner had brought her claim to the Fund prior to suit, he would have considered it (Pet. Br. 23-26). Petitioner cites no deposition testimony from this or any other director to the effect that her pre-suit demand would have been futile, because there was none.

Petitioner's predictions of "gloom and doom" resulting from the adoption of the Seventh Circuit demand rule are no more particularized than were the allegations of futility contained in her amended complaint—and they deserve the same fate.

III. THE ARGUMENT RAISED ONLY BY THE SECURITIES AND EXCHANGE COMMISSION IN ITS *AMICUS* BRIEF THAT PROXY CLAIMS UNDER SECTION 20(A) ARE NOT DERIVATIVE IS NOT PROPERLY BEFORE THIS COURT.

The Securities and Exchange Commission seeks through its *amicus* brief in these proceedings to further its own agenda with respect to an issue which is not properly before this Court. Specifically, the SEC urges this Court to reverse the decisions of both federal courts below and remand this case on the uncertified ground that petitioner's proxy claim is not derivative for purposes of Fed. R. Civ. P. 23.1. Respondent KFS's brief on this appeal carefully analyzes the SEC's arguments and demonstrates conclusively why this Court should not consider them (KFS Br. Sec. IV).

The Fund agrees with the KFS analysis and, accordingly, adopts the KFS brief and argument on this issue.[18]

The SEC speaks of the value of "private enforcement" as a supplement to Commission action in the context of securities regulation (SEC Br. 1). In the next breath, however, the SEC proposes a rule which would deny corporations standing to protect their rights under the securities laws, leaving the field to shareholders as the sole private guardians of the corporate interest in connection with proxy solicitation claims. If the SEC's goal is to encourage private enforcement of securities laws, wisdom would suggest a regulatory scheme which permits the party most directly interested to vindicate its rights.

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[18] The Fund wishes to emphasize that adoption of the SEC's argument would render corporations powerless to protect their legitimate interests in the securities field. The rule proposed by the SEC is not limited in application to the proxy claims brought under the 1940 Act. Rather, it appears to place limitations on the rights of *all* corporations to bring proxy claims, whether under section 20 of the Investment Company Act, section 14 of the Securities and Exchange Act of 1934, or any statutory provision dealing with proxy solicitation. Thus, for example, a target corporation would no longer be permitted to protect its legitimate interest in making sure that its shareholders receive truthful information in the proxies distributed by an acquiring corporation or its agents.

CONCLUSION

For the foregoing reasons, the judgment of the United States Court of Appeals for the Seventh Circuit, affirming the dismissal of petitioner's section 20(a) claim, should be affirmed.

Respectfully submitted,

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(10)

No. 90-516

IN THE
Supreme Court of the United States
OCTOBER TERM, 1990

JILL S. KAMEN,
Petitioner,
v.
KEMPER FINANCIAL SERVICES, INC. and
CASH EQUIVALENT FUND, INC.,
Respondents.

On Writ of Certiorari
To The United States Court of Appeals
For The Seventh Circuit

BRIEF OF RESPONDENT KEMPER FINANCIAL SERVICES, INC.

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QUESTIONS PRESENTED

1. Whether both courts below erred in holding that the conclusory allegations in petitioner's complaint were insufficient to excuse her failure to make a demand before initiating this suit, in which petitioner alleges no fraud by the Fund or KFS, but claims only that certain correct, but allegedly "misleading," information was included in proxy materials distributed to the Fund's shareholders.

2. Whether, as a matter of federal common law and policy, the futility exception to the demand requirement should be abolished in federal question cases, to protect the demand requirement from being swallowed up by the exception, to eliminate unnecessary and time-consuming satellite litigation over the question whether demand should be excused in particular circumstances, and to ensure that corporate directors will be permitted in the first instance to address shareholder complaints before a derivative action may be filed in federal court.

RULE 29.1 LISTING

The following are parent corporations and subsidiaries (not wholly owned) of Kemper Financial Services, Inc.:

Parent Corporations:

Kemper Financial Companies, Inc.
Kemper Corporation
Lumbermens Mutual Casualty Company

Subsidiaries Not Wholly Owned:

Dimensional Fund Advisers, Inc.
Investors Fiduciary Trust Company
Kemper International Management, Inc.
BSN Gestion de Patrimonios, S.A.

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STATUTES AND RULES INVOLVED

In addition to the statutes and rules cited by petitioner, this case involves Sections 80a-2(a)(19)(B), 80a-10(a), and 80a-15(c) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-2(a)(19)(B), 80a-10(a), and 80a-15(c), which are set forth in an appendix to this brief.

STATEMENT OF THE CASE

1. The Parties

Petitioner Jill S. Kamen is a shareholder in respondent Cash Equivalent Fund, Inc. (the "Fund"), a money market mutual fund registered as an investment company under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* ("the 1940 Act") (J.A. 38-39). Respondent Kemper Financial Services, Inc. ("KFS") is the investment adviser and underwriter of the Fund (J.A. 40).

The Fund is designed to provide cash management services to clients of broker-dealers (R. 64, Ex. B at 2). The Fund differs from "retail" money market mutual funds such as Kemper Money Market Fund ("KMMF"), and provides specialized services that typically are not available from a retail money market fund.[1] The Fund is designed for investors who want the added services the Fund provides and are willing to pay for these services in the form of somewhat higher fees and lower yields (C.A.J.A. 178-82, 185).[2]

[1] These services include cash management capabilities to invest, redeem, and transfer funds automatically, thereby insuring that an investor can earn income while awaiting investment decisions and pay for investments without writing checks (J.A. 93-94). Certain broker-dealers also offer check writing privileges and related services (R. 64, Ex. B at 7).

[2] "C.A.J.A." refers to the joint appendix filed in the court of appeals. "C.A. Br." and "C.A.R. Br." refer, respectively, to petitioner's opening and reply briefs in the court of appeals.

At the time suit was filed, the Fund had 10 directors (J.A. 101-03). Only three were "interested persons," *i.e.*, persons affiliated with the Fund, its investment adviser, underwriter, or legal counsel; the other seven directors were wholly independent (*id.*). The Fund's percentage of independent directors exceeded that required by the 1940 Act. *See* 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19)(B).

2. District Court Proceedings

On May 10, 1985, petitioner filed a one-count complaint "on behalf of the Fund," asserting claims against KFS and the Fund under Sections 20(a) and 36(b) of the 1940 Act, 15 U.S.C. §§ 80a-20(a), 80a-35(b). The complaint alleged that KFS had violated the proxy provisions of Section 20(a) and breached its fiduciary duty under Section 36(b) by charging excessive investment advisory fees (J.A. 9-16).

The purported proxy violation stems from one sentence in a proxy statement distributed in 1984, seeking continued approval of the fees charged by KFS. That sentence stated that KFS charged KMMF "a maximum fee of .50 of 1% of the first $215,000,000 with lesser rates on additional assets" (J.A. 13). This sentence appeared in a section of the proxy statement, which, in accordance with applicable regulations, listed the 14 other funds for which KFS also provided advisory services, as well as the rates charged to each (September 12, 1984 Proxy Statement of Cash Equivalent Fund, Inc. ("1984 Proxy") 6-7).[3] Although it accurately described the maximum fee that KFS charged to KMMF, petitioner contends that the statement "misleadingly described the fees charged" simply because it did not list the precise amount of the lesser rates

[3] The 1984 Proxy, as well as the November 5, 1985 Proxy Statement ("1985 Proxy") referred to herein (*see* p. 25, n. 17, *infra*), are not part of the record. Both, however, are public records (*see* 12 C.F.R. § 4.15(a)(7) (1990)) and thus may be judicially noticed. *See* Fed. R. Evid. 201; *Massachusetts* v. *Westcott*, 431 U.S. 322, 323 n.2 (1977) (per curiam); *Standard Havens Prods.* v. *Gencor Indus.*, 897 F.2d 511, 514 n.3 (Fed. Cir. 1990).

charged on additional assets (J.A. 13). Petitioner claims that the statement thereby "gave the false impression" that the fees charged to the Fund were lower than those charged to KMMF (*id.*).

Petitioner charged only KFS with improper conduct. She did not sue the Fund's directors individually. Nor did she allege that any director knew of the purportedly misleading statement. Moreover, petitioner did not allege that the statement was false, or that KFS's actions were fraudulent, intentional, or negligent.

The only "harm" purportedly caused by the alleged Section 20(a) violation was approval of the investment management agreement. The sole relief requested under Section 20(a) was return to the Fund of the allegedly excessive fees — the same relief sought under Section 36(b) (*see* J.A. 15). Petitioner's original complaint asserted no justification for failing to make a demand with respect to the Section 20(a) claim (J.A. 14). KFS moved to dismiss the Section 20(a) claim on two grounds: (1) petitioner had failed to make a demand, and (2) because petitioner only sought return of allegedly excessive fees, her claim was actionable only under Section 36(b), and not under Section 20(a) (R. 8).[4]

Petitioner conceded that the pleading requirements of Fed. R. Civ. P. 23.1 applied to her Section 20(a) claim (R. 16). Thus, petitioner filed an amended complaint which attempted to explain her failure to make a demand, alleging that demand would be futile because: (1) the seven non-interested directors on the 10-member board received "aggregate remuneration of approximately $300,000 a year" for serving as directors of this and other funds; (2) the directors voted to send out the proxy statement; (3) a demand would be tantamount to asking the directors to sue themselves, and they

[4] The Fund joined in this motion and asserted that a demand should have been made (R. 11). However, the Fund took no position on the merits of the proxy violation allegations (J.A. 24-25).

would not prosecute litigation in an appropriate manner in any event; (4) the directors were "under the control" of KFS and Kemper Corporation; (5) the Fund had sought to dismiss the original complaint on "substantive grounds"; and (6) "federal policy" reasons disfavored application of the demand requirement in these circumstances (Pet. App. 92a-93a).[5]

KFS persisted in its motion to dismiss petitioner's amended complaint on the ground that the conclusory allegations upon which she sought to avoid demand did not satisfy the particularity requirements of Rule 23.1 (R. 21). On February 2, 1987, the district court dismissed petitioner's Section 20(a) claim, holding that her allegations did not comply with Rule 23.1 (Pet. App. 56a). After discarding petitioner's conclusory allegations, the court found that her futility argument rested on two contentions: (1) that the directors were compensated for their services, and (2) that they voted to distribute the allegedly misleading proxy statement. The district court concluded that these allegations were insufficient to excuse a demand.

Specifically, the district court found that petitioner's allegation concerning the directors' remuneration fell far short of demonstrating "futility" (Pet. App. 52a-53a):

> The mere fact that the directors receive substantial remuneration for acting as directors does not, in and of itself, establish that they could not impartially review the merits of [petitioner's] excessive fee claim. If the fact that a director is paid for his services was sufficient to avoid Rule 23.1, Rule 23.1 would be rendered ineffective.

[5] Petitioner filed her amended complaint on July 23, 1985 (R. 17). On December 8, 1986, she filed a supplemental amended complaint (Pet. App. 85a-95a) which contains identical allegations concerning the proxy claim and the purported reasons that demand was futile. We will refer to the supplemental amended complaint.

The district court also found that futility was not established by petitioner's allegation that the directors had approved the proxy statement (Pet. App. 53a-54a; citations omitted):

> The courts have consistently held that "mere approval of challenged conduct is insufficient to render the demand futile." . . . . As the First Circuit aptly remarked, "It does not follow . . . that a director who merely made an erroneous business judgment in connection with what was plainly a corporate act will 'refuse to do [his] duty on behalf on [sic] the corporation if [he] were asked to do so.' Indeed, to excuse demand in these circumstances — majority of the board approval of an allegedly injurious corporate act — would lead to serious dilution of Rule 23.1."

Petitioner filed a motion to reconsider (J.A. 67-113). She did not argue that the court had erred by applying federal law to the demand requirement, or that the court should have applied Maryland law. Nor did petitioner cite any legal authorities to show that she had pleaded facts sufficient to excuse a demand (R. 66). Instead, petitioner attempted to support her position solely by referring to the allegations of her complaint and to excerpts from the depositions of five directors taken some 17 months after the complaint had been filed (J.A. 70-75). Although several of the directors indicated that they had then reviewed the complaint and believed that it had no merit (J.A. 72, 73, 76, 83), the directors who were asked also indicated that they would have considered the claim if a demand had been made (*e.g.*, J.A. 71, 85).

The district court denied the motion for reconsideration for two reasons (Pet. App. 61a-65a). First, the court concluded that the relevant question was not whether the directors would file suit, but whether they would be impartial in deciding whether to sue. The court found that petitioner had not alleged sufficient facts to show that the directors would not have acted properly, if petitioner had presented a

demand. Second, the court emphasized that futility is to be determined as of the time suit is commenced, not at some later time after adversarial positions may have hardened. "[T]he mere fact that the directors indicate their disagreement with the lawsuit after it is filed does not indicate that they would not have considered a timely demand" (Pet. App. 65a).

3. Seventh Circuit Proceedings

On appeal, petitioner argued that the dismissal of the Section 20(a) derivative claim should be reversed because her complaint pleaded facts sufficient to excuse demand. The Seventh Circuit disagreed, stating that the district court "thought [petitioner's] allegations insufficient to excuse a demand under Rule 23.1, as do we" (Pet. App. 6a).

After concurring in the district court's holding as to the inadequacy of petitioner's allegations of futility, the Seventh Circuit went on to hold that the futility exception should be eliminated as a matter of federal common law. Because futility was the only ground upon which petitioner attempted to justify her failure to make a demand, the court concluded that the Section 20(a) claim was properly dismissed for this reason as well (Pet. App. 20a).

The Seventh Circuit observed that the futility exception had generated such extensive and unproductive satellite litigation as to swallow the demand rule and "sap[] the potential role of the demand requirement as an alternative dispute resolution mechanism" (Pet. App. 14a). The Seventh Circuit further noted that other courts also had "display[ed] impatience with the futility exception" (Pet. App. 18a). In addition, the court determined that existing precedent did not mandate continued recognition of a futility exception in federal cases (Pet. App. 18a-20a). The court therefore concluded that the better rule would be for "claims of futility [to] be tested by *making* the demand rather than by arguing about hypotheticals" (Pet. App. 20a; emphasis in original).

The court of appeals also suggested that dispensing with the futility exception would allow the demand requirement to fulfill its proper function as an "exhaustion requirement" in federal law cases (Pet. App. 14a). In this way, the federal courts would not be burdened with litigation until directors had been given an opportunity to determine in the first instance what action, if any, should be taken on behalf of the corporation.[6] Thus, before a shareholder could file a lawsuit on behalf of the corporation, the directors would be permitted to consider whether to pursue litigation; whether the costs and disruption of litigation outweigh its benefits, which may be small or speculative; and whether to explore alternative means of dispute resolution (Pet. App. 9a-10a).

In the Seventh Circuit, petitioner again asserted that the relevant issues were controlled by federal law (C.A. Br. 14-15). In her reply brief, petitioner continued to argue that federal law was controlling, but also suggested, for the first time, that Maryland law should apply in the event that the court chose to apply state law (C.A.R. Br. 10). The Seventh Circuit held that federal law should be applied. In addition, however, the court treated petitioner's suggestion as if it were an affirmative assertion that Maryland law should apply, but held that the assertion "comes too late . . . ." (Pet. App. 9a).

This Court granted review limited to the question addressing the dismissal of the derivative claim under Section 20(a) for failure to make a demand.

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[6] The Seventh Circuit noted that if a demand is made and "the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law" (Pet. App. 20a). The Seventh Circuit specifically rejected any link between a demand and the imposition of any particular standard of review with respect to the directors' response (Pet. App. 13a).

INTRODUCTION AND SUMMARY OF ARGUMENT

1. The only question properly presented in this case is whether the court of appeals erred when it upheld the dismissal of petitioner's Section 20(a) claim on the two independent grounds that (1) petitioner had not pleaded facts sufficient to show that a demand would have been futile, and (2) as a matter of federal common law, futility should be abolished as an exception to the demand requirement. Although this is the only question properly presented on the pleadings and record in this case, petitioner and the Commission ask this Court to reach out and decide two questions which were never raised or decided below, which were not presented for review in the petition for certiorari, and which therefore should be left for another day.

First, the Commission suggests that the decisions below should be reversed on the theory that Section 20(a) actions cannot be derivative, and that no demand could therefore be required in this case. The Commission cites no relevant authority in support of this novel assertion, which is incorrect in any event. More important, petitioner and her experienced counsel have never made this argument in the district court, in the court of appeals, or in this Court. Whether Section 20(a) actions ever can be brought derivatively is not properly before the Court at this time.

Second, petitioner and the Commission both contend that the need for a demand in this Section 20(a) case is to be determined under Maryland, rather than federal, law. This, too, is an issue that is not properly presented for review. Petitioner never asserted in the district court that the issue was controlled by Maryland law. On the contrary, petitioner relied only on federal law. Similarly, petitioner's opening brief in the Seventh Circuit made no mention of Maryland law. Petitioner's only reference to Maryland law came in her reply brief, and she did not argue even then that Maryland law provided the rule of decision. She argued only that the

court of appeals should look to Maryland law in the event the court found that federal law was not controlling.

The Seventh Circuit held that federal law was controlling, but rejected petitioner's Maryland law argument on the additional ground that issues cannot be raised for the first time in a reply brief (Pet. App. 8a-9a). Petitioner and the Commission apparently believe that the court of appeals erred in applying that neutral and well-established rule. If this Court were to hold that the court of appeals had no right to determine that this issue was waived by virtue of petitioner's failure to raise it, if at all, until the reply brief, that holding would inflict fundamental, systemic damage on our appellate courts, which must remain free to insist on the orderly presentation of the cases before them.

2. Both courts below correctly concluded that the Section 20(a) claim should be dismissed for failure to plead facts sufficient to excuse demand. The district court gave effect to the principle that demand may be excused, if at all, only where the complaint alleges specific facts to show that the directors are incapable of exercising independent judgment. Where, as here, the complaint alleges no factual basis for asserting that the directors could not be fair and impartial, demand cannot be excused. The kind of "facts" petitioner alleged fail to satisfy the federal common law standards which the district court correctly applied. Nor would petitioner's allegations satisfy the law of Maryland.

Petitioner did not allege that any director did anything improper. The only "facts" which petitioner asserted were that the directors were compensated for their services, and that they voted to distribute the proxy materials. Both courts below properly concluded that the demand requirement effectively would be eliminated if such allegations were deemed sufficient to excuse demand.

The court of appeals affirmed the district court's holding that the Section 20(a) claim should be dismissed on the

ground that petitioner had not alleged facts sufficient to excuse demand. In addition, the court of appeals affirmed the dismissal on the separate ground that the futility exception was swallowing the demand requirement itself and therefore should be eliminated in federal law cases. The court of appeals reviewed the burgeoning body of case law addressing the futility exception, observing that enormous resources had been wasted in litigation over the hypothetical, but necessarily fact-specific, question whether a particular board would have acted properly if a demand had been made. The court of appeals recognized the growing dissatisfaction with the futility exception expressed in federal appellate decisions narrowly applying the exception, and in the recommendations of various expert organizations and commentators.

The court reasoned that demand, without a futility exception, would function as an exhaustion requirement that would eliminate unnecessary federal litigation and encourage intracorporate dispute resolution. Contrary to petitioner's frequent warnings, this rule does not sound the "death knell" for derivative litigation. The Seventh Circuit made clear that it was not deciding what effect the denial of a demand should have on a subsequent shareholder suit. The court decided only that federal courts should be permitted to address the question of futility based on the history of an actual request, rather than on speculation and guesswork.

The Seventh Circuit's decision, which admittedly went beyond where previous courts have ventured, was correct as a matter of federal law and policy. By eliminating futility as a reason to forego a demand on directors, the Seventh Circuit struck a balance that is correct in any event, but particularly appropriate with respect to a claim under the 1940 Act, which mandates that independent directors act as "watchdogs" over the Fund. The rule fashioned by the court of appeals, which

protects the federal courts from becoming embroiled in collateral litigation over hypothetical claims of "futility," promotes sound judicial administration and corporate governance.

ARGUMENT

I. BOTH COURTS BELOW PROPERLY DISMISSED THE SECTION 20(a) CLAIM BECAUSE PETITIONER FAILED TO PLEAD SUFFICIENT FACTS TO EXCUSE MAKING A DEMAND.

The courts below took somewhat different, but convergent paths. The district court found that petitioner had fallen far short of alleging with particularity facts sufficient to establish futility. The court of appeals agreed with the district court's analysis and adopted that holding as its own, but elected to go farther and hold that preservation of the demand requirement necessitated abolition of the futility exception in federal cases.[7]

The district court's decision has ample support in the record, as the court of appeals correctly held (Pet. App. 6a, 17a). Based upon a careful analysis of Paragraph 17, which contains petitioner's only allegations pertaining to futility (Pet. App. 92a-93a), the district court correctly found that the

[7] Petitioner makes much of the fact that the court of appeals articulated a second basis to support the result reached by the district court, asserting that the court of appeals would not have issued "such a doctrinaire opinion if it could reach the same result by a less revolutionary route" (Pet. Br. 13). Petitioner's argument ignores the central fact that the court of appeals squarely adopted the district court's reasoning, stating that the district court "thought these allegations [of futility] insufficient to excuse a demand under Rule 23.1, as do we" (Pet. App. 6a). This is a point not lost on the Commission, which correctly states that the court of appeals agreed "with the district court that the petitioner's allegations of futility were inadequate" (SEC Br. 4).

particularity requirements of Rule 23.1 were not satisfied.[8] There is no basis for concluding that the district court abused its discretion. *See, e.g., Lewis* v. *Graves*, 701 F.2d 245, 248 (2d Cir. 1983); *Greenspun* v. *Del E. Webb Corp.*, 634 F.2d 1204, 1208 (9th Cir. 1980). Indeed, petitioner cannot cite a single federal or state case in which any court has excused a demand based on boilerplate allegations like those pleaded here.[9]

A. Both Courts Below Followed Unanimous Case Law In Holding That The Facts Alleged In Petitioner's Complaint Did Not Establish That A Demand Would Be Futile.

In the leading case of *In re Kauffman Mut. Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), the First Circuit succinctly stated the federal rule with respect to the sufficiency of facts pleaded to excuse the making of a demand. In that case, the court held that demand will be excused only upon a particularized showing that the directors have an antagonism for the corporate interest that renders them incapable of discharging their duties. *Id.* at 263.

[8] Whether the demand requirement rests on Rule 23.1 or the underlying substantive law, or both, is a question which this Court left open in *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 532-33 n.8 (1984); *but cf.* 464 U.S. at 543-44 (Stevens, J., concurring) (Rule 23.1 "concerns itself solely with the adequacy of the pleadings"). However, the requirement of pleading with particularity the reasons for not making a demand is an established exception to the liberal notice pleading rules generally applicable to federal complaints. *See In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Vernars* v. *Young*, 539 F.2d 966, 968 (3d Cir. 1976). Thus, the district court correctly looked to federal law insofar as it based its ruling on the insufficiency of the pleadings. *See* 7C C. Wright, A. Miller, M. Kane, *Federal Practice & Procedure* § 1831 at 100 (1986).

[9] Given the insubstantiality of petitioner's futility allegations, it is not surprising that she cites them but once in her brief (Pet. Br. 3-4), and does not even attempt to refute the unanimous case law holding such allegations insufficient to establish futility.

The *Kauffman* court rejected the plaintiff's conclusory assertions that demand was futile, that the majority, non-affiliated directors were under the control of the minority, and that the directors had been involved in the contested decision. The First Circuit explained that before taking the exceptional step of excusing demand, specific and compelling facts must be presented (*id.*; citation omitted):

> [I]t is normally the directors, not the stockholders, who conduct the affairs of the company. Hence, to be allowed, sua sponte, to place himself in charge without first affording the directors the opportunity to occupy their normal status, a stockholder must show that his case is exceptional. His initial burden is to demonstrate why the directors are incapable of doing their duty, or as the Court has put it, to show that "the antagonism between the directory and the corporate interest . . . be unmistakable."

Thus, a demand may be excused as futile only if the pleadings demonstrate with particularity that the directors are not disinterested and independent decisionmakers. *E.g., Graves*, 701 F.2d at 248; *Greenspun*, 634 F.2d at 1209-10. The shareholder may not merely state in conclusory terms that he made no demand because it would have been futile. *E.g., Greenspun*, 634 F.2d at 1209; *Kauffman*, 479 F.2d at 263.

The district court's decision in this case fully accords with federal precedent. When stripped of conclusory assertions, petitioner's complaint contains only two relevant factual allegations: (1) the directors were compensated for their services, and (2) they voted to send out the proxy solicitation. Neither is sufficient to excuse demand.

The district court correctly recognized that the demand requirement effectively would be eliminated if the mere payment of directors' fees were sufficient to excuse a demand (Pet. App. 53a). Here, petitioner did not even detail the fees

which the Fund paid to each director, but only stated the aggregate amount which all independent directors received from the various funds which they served as directors. In addition, petitioner did not allege that any director received a substantial portion of his income from fund-related director fees. Nor did she suggest that the payment of fees to the directors depended upon the way they voted. Petitioner simply attempted to impugn the integrity of the non-interested directors by asserting that they became "dependent upon and subservient to KFS and Kemper Corporation" merely by virtue of accepting a fee for their services (Pet. App. 92a). The district court correctly rejected this wholly unsupported conclusion which, if accepted, would lead to the absurd result that demand always would be deemed "futile" unless the directors served without compensation. *Accord Elfenbein* v. *Gulf & Western Indus.*, 590 F.2d 445, 450-51 (2d Cir. 1978); *Poland* v. *Caldwell*, 1990 WL 158479 (E.D. Pa. 1990) (available on Westlaw); *Shields ex rel. Sundstrand Corp.* v. *Erickson*, 710 F. Supp. 686, 692 (N.D. Ill. 1989); *In re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986).

Petitioner admits that only three of the Fund's 10 directors are "interested," but contends that demand nonetheless would have been futile because "[i]t would be tantamount to asking the directors to sue themselves" (Pet. App. 93a). Courts have deemed this same boilerplate allegation insufficient to excuse demand. *E.g., Graves*, 701 F.2d at 249; *Pullman-Peabody Co.* v. *Joy Mfg. Co.*, 662 F. Supp. 32, 35 (D.N.J. 1986). Petitioner's further allegation that the directors voted to distribute the proxy statement (Pet. App. 92a) also is insufficient to excuse her failure to make a demand. *E.g., Graves*, 701 F.2d at 248 (noting there is ample authority in the courts of appeals to establish that mere acquiescence is insufficient to excuse demand).

In addition, petitioner's complaint does not allege improper conduct by the Fund, but only by KFS. Because no

Fund director is alleged to have done anything improper, this action does not ask the board to sue itself. The only relief sought is the return to the Fund of allegedly excessive fees. If the directors, after considering the merits and other relevant factors, were to conclude that the Fund's overall interest would be advanced by pursuing the claim, they would have no motive for failing to do so.[10]

Petitioner suggests, as she did in the district court, that futility was established because several directors testified (some 17 months into the litigation) that petitioner's claims lacked merit (Pet. Br. 23-26). That argument is both factually misleading and legally irrelevant. As a factual matter, the Fund's initial answer took no position on the merits of petitioner's proxy claim (J.A. 25). Only months later did several individual directors indicate at depositions that they then believed, based on their review and knowledge of the facts, that the proxy claim lacked merit (J.A. 72, 73, 76, 83).

Moreover, in the deposition testimony quoted by petitioner, one director, David W. Belin, stated plainly that "if someone came to me as a shareholder and said they believed there was some merit [to a claim], at least I would give it some consideration" (Pet. Br. 25). Petitioner cannot point to any statement by Mr. Belin — or any other director — which

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[10] Significantly, the complaint does not contain a single allegation that any Fund director knew of the allegedly misleading nature of the proxy statement at the time it was distributed. Nor does the complaint allege that any omission was the result of fraud by KFS or any Fund director. Thus, petitioner's mischaracterization of her case as one involving proxy "fraud" (*see* Pet. Br. i) — which she repeats no fewer than 11 times in her opening brief — has no basis in the complaint. Not only that, petitioner now goes so far as to suggest that "[t]he directors are the very perpetrators of the proxy fraud complained of" (Pet. Br. 5). Petitioner cannot amend her pleadings by unsupported statements in her brief. Indeed, petitioner already has amended her verified complaint twice, and she surely would have alleged "fraud" had she been able to do so, consistent with Fed. R. Civ. P. 11.

even implied that they would not have given fair consideration to petitioner's claim had a demand been made.[11]

At all events, this deposition testimony is irrelevant as a matter of law. *Grossman* v. *Johnson*, 674 F.2d 115, 123 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982); *Cramer* v. *GTE Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied* 439 U.S. 1129 (1979). As the district court stated, both in its initial opinion and in its opinion on reconsideration (Pet. App. 54a-55a, 64a; citations omitted):

> The futility of a demand should be gauged at the time the suit is commenced. . . . The fact that a corporation resists the suit or demands that the requirements of Rule 23.1 be met is insufficient to establish that the board would reject a demand if the shareholder had requested it to act.

The district court thus correctly applied the settled legal principle that assertions made after litigation has commenced, when positions may have hardened, say nothing about how a board would have reacted if it had been notified of a problem by a demand rather than a lawsuit.[12]

The correctness of the court's analysis is particularly obvious here, where the statutory policy of the 1940 Act underscores the need for faithful enforcement of the demand

[11] Indeed, the supplemental amended complaint (Pet. App. 85a-95a) makes no reference to the deposition testimony, although the depositions were concluded before it was filed.

[12] Contrary to petitioner's assertion (Pet. Br. 16-17 & n.8), neither this Court's decisions nor those of the Seventh Circuit establish that "post-litem board opposition is sufficient to excuse demand." In *Smith* v. *Sperling*, 354 U.S. 91 (1957), the sole issue was whether the corporation was to be realigned as a party plaintiff for jurisdictional purposes. As other courts have recognized, *Smith* did not involve allegations of post-litigation conduct. *See Kauffman*, 479 F.2d at 265 n.5; *see also* Pet. App. 18a-19a. In *Nussbacher* v. *Continental Ill. Nat'l Bank & Trust Co.*, 518 F.2d 873, 875 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976), which was overruled by the decision below, futility stemmed from *pre*-litigation conduct and comments.

requirement. A central purpose of the 1940 Act is to ensure the availability of neutral decisionmakers, both by limiting the percentage of directors who may be interested persons, within the broad definition of the Act, 15 U.S.C. § 80a-2(a)(19)(B), and by providing that only the disinterested directors may approve an investment adviser's contract, 15 U.S.C. §§ 80a-10(a), 80a-15(c). By implementing these requirements, Congress intended disinterested directors of mutual funds to be "independent watchdogs" over the funds. *Burks* v. *Lasker*, 441 U.S. 471, 484 (1979). Finding futility based on the conclusory and inadequate allegations in petitioner's complaint would have the undesirable effect of "muzzl[ing]" these watchdogs, *id.* at 485, and would encourage the filing of lawsuits without first allowing the disinterested directors to review the matter and consider, among other things, whether the controversy can be resolved in some less expensive and more efficient manner.

B. Petitioner's Allegations Would Not Be Sufficient To Excuse Demand Even Under Maryland Law.

Both courts below were correct in applying federal law. In addition, petitioner's eleventh-hour contention that her allegations would be sufficient to excuse demand under Maryland law is not properly before the Court.[13] Without waiving our objection, however, we will briefly address that argument to show that the judgment would have to be affirmed in any event, because petitioner's allegations are insufficient even under Maryland law.

Although Maryland law recognizes a futility exception, the standards for its application are essentially the same as those which have been applied in the past under federal law. *See Zimmerman* v. *Bell*, 585 F. Supp. 512, 514 (D. Md. 1984). A demand upon directors has been excused under

[13] As KFS demonstrates below (*see* pp. 34-41, *infra*), petitioner waived any claim that Maryland law applies in this case, and federal common law should apply in any event.

Maryland law only when the complaint alleges fraud, active participation in the wrongdoing, or conspiracy to violate federal law and regulations. *See, e.g., Parish* v. *Maryland & Va. Milk Producers Ass'n*, 250 Md. 24, 242 A.2d 512, 545 (Md. Ct. App. 1968) (directors sued individually for fraud, concealment, gross negligence, and waste of corporate assets), *cert. denied*, 404 U.S. 940 (1971); *Bell*, 585 F. Supp. at 514 (all members of board sued for active participation in wrongdoing); *Burt* v. *Danforth*, 742 F. Supp. 1043, 1048 (E.D. Mo. 1990) (applying Maryland law) (entire board allegedly engaged in conspiracy to violate federal law and regulations, including intentional and fraudulent activities).

At the same time, cases applying Maryland law make clear that mere allegations of negligent breach of fiduciary duty, interest due to compensation, and board control by interested parties cannot excuse demand. *See, e.g., Burt*, 742 F. Supp. at 1048; *cf. Rosengarten* v. *Buckley*, 565 F. Supp. 193, 198 (D. Md. 1982) (in a case involving shareholder demand, court stated that "a plaintiff may not escape the demand requirement by characterizing a suit which is really based on a breach of fiduciary duty as a fraud action").

In the case at bar, petitioner made no allegations which even approach those that have been found sufficient under Maryland law. It is understandable, therefore, that petitioner's argument under Maryland law (Pet. Br. 11-13) contains no reference to any of the actual allegations in her complaint, which she now attempts to recast as if they alleged fraud. However, petitioner does not advance her cause with this belated and transparent exercise in alchemy. As *Rosengarten* confirms, courts must look beyond the label to see whether in fact fraud is involved. *See* 565 F. Supp. at 198. In

this case, petitioner's present incantation of "fraud" cannot serve to reconstitute the allegations in her complaint.[14]

In the case at bar, petitioner filed three different verified complaints, the last of which came after substantial discovery had been completed. Even then, petitioner obviously did not believe that she could, in good faith, allege fraud; nor could she allege even a breach of fiduciary duty by any director. These pleadings cannot suffice to excuse demand under Maryland law, federal law, or any other law which petitioner might suggest in her reply brief.

II. THE COURT OF APPEALS CORRECTLY HELD THAT THE FUTILITY EXCEPTION SHOULD NOT APPLY IN THIS DERIVATIVE ACTION UNDER SECTION 20(a) OF THE INVESTMENT COMPANY ACT OF 1940.

The court of appeals in this case adopted the straightforward rule that a shareholder must make a demand on the directors before filing a derivative action. The court reasoned that the futility exception (1) had engendered massive

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[14] Petitioner takes considerable liberties not only in attempting to recast her complaint as one alleging "fraud" (*see* p. 15, n.10, *supra*), but also in describing the authorities that she cites. First, the *Parish* court did not hold that demand on the directors "was excused because the directors affirmed their support of management's action after the commencement of the law suit" (Pet. Br. 11). The cited portion of the opinion addressed demand upon shareholders, not directors. Moreover, the shareholders, not the directors, affirmed their support of management. 242 A.2d at 545-46. Second, petitioner cites *Bell*, apparently for the proposition that fraud vitiates the demand requirement (Pet. Br. 11), but she fails to mention that one of the intervening plaintiffs in *Bell* in fact had made a demand on the board, which had been refused. 585 F. Supp. at 514. Third, petitioner devotes considerable attention to *Oldfield* v. *Alston*, 77 F.R.D. 735 (N.D. Ga. 1978) (Pet. Br. 11-12), but that case purported to apply federal law, not Maryland law, in the cited passage addressing director demand. *See* 77 F.R.D. at 739-40. The *Oldfield* court applied Maryland law only to the issue of demand on shareholders, which was addressed separately in the opinion.

amounts of unnecessary and time-consuming federal litigation over the collateral issue of whether a demand would have been futile, (2) had thereby created a substantial danger that the futility exception would swallow up the demand rule, and (3) had eviscerated the demand requirement as an effective intracorporate means of resolving shareholder disputes.

By dispensing with the futility exception in federal law cases, the court of appeals sought to preserve the demand requirement and permit it to fulfill its proper function as an exhaustion requirement. The court rejected the futility exception only after thoroughly considering relevant legal principles and policy considerations, all of which led to the common sense conclusion that "claims of futility should be tested by *making* the demand rather than by arguing about hypotheticals" (Pet. App. 20a; emphasis in original).

Contrary to petitioner's assertions, rejection of futility as an exception to the demand requirement is neither "doctrinaire" nor "revolutionary" (Pet. Br. 13), but a proper and measured exercise of the power of the federal courts to establish prerequisites ensuring that judicial resources are not squandered on collateral or hypothetical matters. The Seventh Circuit correctly determined that changed circumstances and the necessary evolution of federal common law warrant elimination of futility as an exception to the demand requirement, itself a creature of the federal common law.

A. Abolishing The Futility Exception Benefits The Judicial System And Promotes Intracorporate Dispute Resolution Without Unduly Burdening Plaintiffs.

1. Judicial Economy Favors Elimination of the Futility Exception.

The demand requirement stems, in significant part, from this Court's recognition of the need to regulate the circumstances in which the doors of the federal courts should be opened for derivative claims. In *Hawes* v. *Oakland*, 104 U.S.

450 (1881), this Court recounted the potential abuses inherent in derivative litigation. The Court was concerned not only that derivative actions, if left unconstrained, could undermine the ability of directors to consider shareholder claims in the first instance, *id.* at 454-57, but also that parties might collusively manufacture diversity jurisdiction and thus unnecessarily burden the federal courts. *Id.* at 452-53. The Court's concern did not rest solely in protecting corporations from unnecessary litigation, but also in ensuring that the resources of the federal courts would be devoted to hearing only those cases which required federal judicial action.

In *Hawes*, the Court took aim at both potential abuses when it instituted demand as an exhaustion requirement (*id.* at 460-61):

> [B]efore the shareholder is permitted in his own name to institute and conduct a litigation which usually belongs to the corporation, he should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be made apparent to the court.

The Court thus contemplated that derivative suits would be "a limited exception to the usual rule that the proper party to bring a claim on behalf of a corporation is the corporation itself." *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 531 (1984).

In the intervening 110 years, the futility exception has evolved in a way that has robbed the demand rule of its vitality as an exhaustion requirement. In the *Hawes* era, the federal courts required protection from parties who would foist upon the courts derivative suits with manufactured diversity jurisdiction. Today, the burden on federal courts

comes from the use of the futility exception to avoid recourse to intracorporate means of dispute resolution. As the Seventh Circuit recognized, the futility exception has produced "gobs of litigation" and "[h]undreds of cases opine on whether demand is or is not futile" (Pet. App. 14a).

This multiplicity of collateral litigation is virtually unavoidable under the futility exception. The exception is premised on the view that, if the board is "biased" against bringing suit or taking other appropriate action, then a demand would be useless. Thus, the threshold issue for maintaining a derivative action has become whether bias can be presumed (and demand excused) because of the directors' involvement in the actions being challenged, their alleged misconduct, or their personal relationships with those persons whose conduct is being challenged. Answering this hypothetical, but fact-specific question has been a time-consuming process.

The Seventh Circuit is not alone in recognizing this problem, and the threat that it poses for an already overburdened federal judiciary. The American Law Institute ("ALI"), in recommending abolition of the futility exception, has noted that "[w]hatever the standard used to state the futility exception, close questions are inevitable and consequent litigation predictable over the necessity for demand." ALI, *Principles of Corporate Governance: Analysis and Recommendations* (*"Principles of Corporate Governance"*) § 7.03, Comment at 64 (Tent. Draft No. 8, 1988). Likewise, the American Bar Association Section of Business Law Committee on Corporate Laws ("ABA") has concluded that eliminating the futility exception is desirable because it "eliminates the time and expense of the litigants and the court involved in litigating the question whether demand is required." ABA, *Revised Model Business Corporation Act* § 7.42 at 212-13 (1990) (Official Comment).

The rule adopted by the court of appeals will restore vitality to the demand requirement and promote judicial

economy. If demand leads to the matter being resolved to the shareholder's satisfaction without litigation, that is the best result of all. If litigation ensues notwithstanding a demand, the litigation at least will focus on questions deserving of judicial attention. In either case, requiring demand is preferable to expending vast amounts of time, money, and scarce judicial resources in litigating the hypothetical question whether demand would have been futile.[15]

2. Intracorporate Dispute Resolution Is Advanced By Eliminating The Futility Exception.

The futility exception is based on the theory that a board, in certain exceptional circumstances, may be incapable of rendering a fair and unbiased decision when presented with a demand. In practice, however, the futility exception has been employed routinely as an excuse to avoid allowing a board to consider whether a shareholder grievance warrants no action at all, the filing of a lawsuit by the corporation, or the pursuit of alternative remedies which may be more beneficial than litigation for the corporation and its shareholders.

Shareholder-plaintiffs and their counsel assume that whenever a "wrong" exists, the "wrong" must be redressed at all costs and only by litigation (*see* Pet. App. 16a). Permitting a shareholder-plaintiff to act as if these assumptions were valid, however, brings the futility exception into direct conflict with an important purpose of the demand requirement: to give directors the opportunity to make an informed judgment — before suit is filed by a shareholder — as to whether to commit the resources of the corporation to a lawsuit, or,

[15] The Commission concedes (SEC Br. 24-25 n.23), and KFS agrees, that this case presents no question as to the proper standard of review to be applied to the directors' decision, once a demand has been made and declined.

alternatively, to attempt other less costly ways of addressing the grievance.[16]

When presented with a demand, directors have available a range of intracorporate options for addressing complaints while also avoiding unnecessary litigation. A chief reason that the ALI has recommended abolition of the futility exception, and one that was recognized and endorsed by the court of appeals (Pet. App. 14a), is to encourage implementation of this wide range of intracorporate dispute resolution techniques. ALI, *Principles of Corporate Governance* § 7.03, Comment at 67.

Even when the majority of a board has been involved in the questioned transaction, a variety of corporate responses are available. For example, the board may appoint disinterested directors to a special litigation committee, to review the transaction. *See, e.g., Gaines* v. *Haughton*, 645 F.2d 761, 767-68 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); 13 Fletcher, *Cyclopedia of the Law of Private Corporations* § 6019.50 (1984). If most or all the directors are or may be implicated in the questioned transaction, the board may appoint new directors to review the transaction or request the appointment of a special panel outside the corporation. *See, e.g., In re General Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1078-79 (6th Cir.), *cert. denied*, 469 U.S. 858 (1984); *Haughton*, 645 F.2d at 766-67.

[16] Indeed, it is widely acknowledged that shareholder derivative actions may take the form of strike suits, motivated not by a desire "to remedy wrongs to the corporation, but to induce settlement beneficial to the named plaintiff or his counsel." *Cramer*, 582 F.2d at 275; *see also* W. Klein & J. Coffee, *Business Organization and Finance* 165 (2d ed. 1986); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv. L. Rev. 746, 749 (1960); 7C C. Wright, A. Miller, M. Kane, *Federal Practice & Procedure* § 1831 at 119 (1986). The Seventh Circuit also observed that shareholder-plaintiffs and their counsel may allege futility, and thus seek to avoid a demand, only for the improper reason that a demand might lead to corporate action that would "deprive counsel of fees" (Pet. App. 13a).

In other circumstances, even an interested board may wish to take action, rather than engage in costly litigation on matters which it deems insignificant. The Revised Model Business Corporation Act has eliminated the futility exception precisely for this reason: "[E]ven though no director may be independent, the demand will give the board of directors the opportunity to reexamine the act complained of in light of a potential lawsuit and take corrective action." ABA, *Revised Model Business Corporation Act* § 7.42 at 212 (1990) (Official Comment). As the Seventh Circuit noted in the case at bar (Pet. App. 15a):

> Although directors are unlikely to sue themselves, they may well take some action to palliate the consequences of poorly conceived acts, including their own. Directors want the venture to succeed, and if shown how they can improve its prospects, are likely to act. One mistake at the time of the initial board decision does not imply that the member of the board opposes remedial action.

In addition, the board may pursue internal corrective remedies not available to the plaintiff in a derivative action. "Corporate management may be in a better position to pursue alternative remedies, resolving grievances without burdensome and expensive litigation." *Graves*, 701 F.2d at 247 (citation omitted).[17] As another alternative, the board might

[17] Indeed, if petitioner at bar had notified the board in a timely manner, the board might well have taken action that would have avoided this lengthy and expensive suit. For example, if petitioner had objected to the proxy materials before the shareholders' meeting, a new proxy statement could have been distributed. Even if the objection had been interposed at a later date, the board could have held a special shareholders' meeting. Given the expense of litigation, a board may wish to take such minimal action, even if it would not be required to do so. In fact, the Fund's subsequent proxies have set forth a detailed breakdown of the advisory fees which KFS charged to KMMF (*see* 1985 Proxy at 12; *see also* C.A.J.A. 188). Based on those solicitations, the shareholders have approved KFS's fees, as well as a fee increase.

either enter into a settlement that moots the issue or bring to the plaintiff's attention facts sufficient to show that the lawsuit is not worth pursuing.

Requiring demand, even when it may appear futile, allows a board to pursue these — and perhaps other — intracorporate remedies. These remedies may allow the board to resolve a complaint satisfactorily, and thus avoid the enormous expense, time, delay, and diversion from productive business activities which result from improvident litigation. Giving the board the opportunity to consider these remedies also will relieve the federal courts of the burden of adjudicating disputes that need never have been filed.

3. Plaintiffs With Legitimate Grievances Are Not Unduly Burdened By The Rule Adopted By The Court of Appeals In This Case.

Petitioner objects to the Seventh Circuit's purported application of "quasi-functional analysis" (Pet. Br. 18); disagrees with the Seventh Circuit's assertion that making a demand is a "cheap and quick expedient" (Pet. Br. 19); and argues that requiring demand will put plaintiffs out of court (Pet. Br. 21-23). Petitioner's argument is based on the faulty premise that the federal courts, having required the making of a demand in federal question cases, necessarily will adopt a deferential standard of review for assessing the reasonableness of a board's decision not to sue. However, the Seventh Circuit specifically rejected any notion that the mere making of a demand automatically would require application of a deferential standard of review.

The Seventh Circuit observed that "[f]ederal courts have never embraced Delaware's link between the making of a demand and special deference to the board's decision not to sue . . . [and] [w]e think it would be unwise to do so" (Pet.

App. 12a).[18] Echoing the ALI's judgment that "the need for demand and the standard of judicial review — are logically very distinct," ALI, *Principles of Corporate Governance* § 7.03, Comment at 65, the Seventh Circuit concluded that "when the demand requirement comes from federal common law, the making of a demand does not affect the standard with which the court will assess the board's decision not to sue" (Pet. App. 13a). Thus, petitioner's prediction of doom is far wide of the mark.[19]

Even petitioner recognizes that the only possible "cost" that may be incurred by requiring demand is the inability to file or maintain suit. That cost is minimal and speculative, however, because demand is separated from the subsequent

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[18] Thus, the Commission's discussion of standards of review under Delaware law (SEC Br. 21-23) is particularly irrelevant. No party ever has suggested the applicability of Delaware law.

[19] As the Seventh Circuit made clear (*see* Pet. App. 12a-13a, 17a, 20a), its decision did not accept, reject, or alter any particular standard of review. Thus, the Commission is incorrect in its assertion (SEC Br. 21) that eliminating the futility exception will create confusion about standards of review under state law. The Seventh Circuit plainly stated that in a case where a demand is made and the board declines to sue, "the court can decide whether the board's decision is entitled to respect under state corporate law" (Pet. App. 20a), whatever that law may be. The Commission obscures this point by mischaracterizing the Seventh Circuit's abolition of the futility exception as if it involved the adoption of a "universal demand" requirement (*e.g.*, SEC Br. 21), a term frequently used to describe the ABA and ALI formulations. In this way, the Commission misleadingly implies that the Seventh Circuit also adopted the standards of review contained in those formulations. Eliminating the futility exception to the demand requirement in federal cases will not require federal courts to import the standards of review suggested by the ABA or ALI; nor will it "undermine" state laws that consider futility in determining the applicable standard of review (SEC Br. 23). The Seventh Circuit only dispensed with hypothetical "futility" as a reason not to make a demand; the court made clear that evidence which could demonstrate futility in fact would be relevant in applying the standard of review (Pet. App. 17a). Basing decisions on facts, not guesswork, is the customary mode of judicial decisionmaking and will reduce rather than create confusion.

scope of review to be applied if demand is denied. Requiring demand will lead to an examination of the merits at an earlier stage (when a court reviews a board's actual, rather than hypothetical decision), a result which harms no one. *E.g.*, ALI, *Principles of Corporate Governance* § 7.03, Comment at 65. If the directors are so involved in the transaction that demand indeed would be futile, the directors would merely reject the request, the plaintiff would lose no ground in making the demand, and the case would proceed in the courts.[20] In contrast, disputes over futility can delay resolution of the merits for many years, with significant costs to the courts and the parties.

The difficulty comes only from trying to divine futility in the absence of an actual demand. As the Seventh Circuit aptly noted, "[i]t is easy for the plaintiffs to *say* (and for the defendants to deny) that the board has a closed mind; it is much harder to tell who is right" (Pet. App. 16a; emphasis in original). Requiring demand eliminates that guesswork and allows any ensuing litigation to proceed, as litigation generally does, on the basis of actual facts rather than hypotheticals.

B. Abolishing The Futility Exception Is A Natural Evolution Of Federal Common Law.

In *Hawes*, this Court created the federal common law rule that a shareholder must exhaust his remedies by making a demand on the board of directors prior to commencing a

[20] Petitioner claims that this view is "naive," and that requiring demand would cause shareholder grievances to languish in special litigation committees for years (Pet. Br. 19-21 & n.9). However, petitioner ignores the fact that directors, particularly under the 1940 Act, are subject to standards of behavior which "apply as much to their decisions regarding litigation as to the other decisions they may be called upon to make." *Burks*, 441 U.S. at 481-82 n.10 (citations omitted). These standards provide directors with substantial incentive to act properly and expeditiously with regard to a demand. It is not "naive" to trust that shareholders will take action against directors who might attempt to choke off claims by neglect. Nor is it "naive" to believe that federal courts will enforce these standards against such directors.

derivative action. 104 U.S. at 460-61. The Court's subsequent decisions in *Doctor* v. *Harrington*, 196 U.S. 579 (1905), and *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R.*, 213 U.S. 435 (1909), may be read to assume the existence of a futility exception, but continued recognition of such an exception is not required because neither of these cases, nor any other decision of this Court, has squarely held that this exception should be recognized under federal common law (Pet. App. 18a-20a). Moreover, as the court of appeals also correctly noted, the *Doctor* and *Susquehanna* decisions are "linked" to their time, and to then-prevailing assumptions concerning corporate governance which no longer are valid.

The entire context of business regulation and governance, including the decisionmaking procedures of corporate directors, has changed dramatically in the past 85 years. The period from 1890 until the New Deal (dates which bracket the *Doctor* and *Susquehanna* decisions), when regulation of business corporations was principally a matter of state law, was a free-wheeling period. Public policy "carried the utilitarian attitude about as far as it could go: if the law of corporate organization was legitimated by its utility to business enterprise, legitimacy would be most fully achieved if the law empowered businessmen to create whatever arrangements they found most serviceable." J. Hurst, *The Legitimacy of the Business Corporation in the Law of the United States, 1780-1970* 70 (1970).

These public policy values led to the relaxation or abandonment of state law limits "which the 1880's-type statutes had imposed in behalf of investors, creditors, and general social interests," and thus "reduced the opportunity of creditors or stockholders to police corporate legitimacy through provisions embodied in the corporate structure itself." *Id.* at 70, 160. In turn, these changes "legitimized control by the active [corporate] insiders — promoters, entrepreneurs, top management — who would wield the authority." *Id.* at 70-71. *See also* A. Berle & G. Means, *The Modern Corporation and*

Private Property 138 (1932). In short, the policy of state corporation law from 1890 to 1930 "was to enable businessmen to act, not to police their action." Hurst, *supra*, at 70. In these circumstances, it is understandable that a federal court might not invariably have required a demand to be made.

However, the whole thrust of public policy and legal doctrine changed drastically during the New Deal. With the enactment of the 1940 Act and other federal regulatory schemes,[21] the federal government exposed "corporate decision making to a public accountability unmatched in state law." *Id.* at 91-92. The result has been the creation of standards of conduct which, as this Court has recognized, "apply as much to [corporate] decisions regarding litigation as to the other decisions they may be called upon to make." *Burks*, 441 U.S. at 481-82 n.10 (citations omitted). These and other standards, in turn, have provided the impetus for developments in corporate governance, such as special litigation committees and the appointment of new directors or outside panels to review questioned transactions, to better ensure compliance with these standards.

As the Seventh Circuit correctly observed, these legal standards and mechanisms for corporate decisionmaking were not part of the landscape when *Doctor* and *Susquehanna* assumed the need for a futility exception (Pet. App. 19a-20a). Boards of directors did not use — and were not required to use — committees of disinterested directors to decide matters relating to interested directors. Certainly, no corporate entities were then required to conduct their activities, as is the Fund by virtue of the 1940 Act, through a board which has a substantial percentage of independent directors (*see* pp. 16-17, *supra*). In sum, this Court has never endorsed a futility exception within the present framework of extensive federal regulation which has come into existence only in the past 60 years. Nor should it do so now.

[21] *E.g.*, Securities Act of 1933, 15 U.S.C. § 77a *et seq.*; Securities Exchange Act of 1934, 15 U.S.C. § 78 *et seq.*

The Seventh Circuit, in an effort to improve judicial administration, determined that the futility exception should be abolished. Rather than being "revolutionary" (Pet. Br. 13), the Seventh Circuit's decision reflects a change which stands squarely in the tradition of the common law and has the important and inherently conservative purpose of preserving the demand requirement against erosion.

As the Seventh Circuit noted (Pet. App. 18a), its decision follows from several decisions in which the courts of appeals have expressed impatience with the futility exception.[22] The Seventh Circuit is not alone in noting this trend. The ALI likewise has observed the "recent trend" of federal courts "to require demand in circumstances where the case law of an earlier generation would have excused it." ALI, *Principles of Corporate Governance* § 7.03, Reporter's Note at 76 (citations omitted). In addition, three states recently have eliminated the futility exception.[23]

Many knowledgeable voices have joined together in urging that the futility exception be abolished. The ALI, for example, has recommended that the demand requirement should simply be understood as an exhaustion requirement. *Id.* § 7.03, Comment at 64-71. Tentative Draft Number 8 proposes that a derivative action may not be commenced until the shareholder has made "a written demand upon the board of directors of the corporation, requesting it to prosecute the action or take suitable corrective action, unless . . . the [shareholder] makes a specific showing that irreparable injury to the corporation would otherwise result." *Id.*

[22] Although other courts of appeals have not dispensed with the exception altogether, they have been "creative in denying that a demand would be futile even when it is pellucid that the board is not about to authorize a suit" (Pet. App. 18a; citations omitted).

[23] *See* Fla. Gen. Corp. Law § 607.0740(2) (1989); Ga. Bus. Corp. Code § 14-2-742 (1990); Mich. Bus. Corp. Act § 450.1493a(a) (1989).

§§ 7.03(a), (b) at 63-64. Similarly, the Revised Model Business Corporation Act provides categorically that "[n]o shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action . . . ." ABA, *Revised Model Business Corporation Act* § 7.42 at 212 (1990).

As the ALI and the ABA have recognized, abolishing futility as a reason to forego demand will accomplish two interrelated purposes: (1) eliminating the time and expense of litigating collateral issues relating to the hypothetical futility of demand, and (2) promoting intracorporate resolution of the dispute. On the other hand, retaining the futility exception would greatly endanger the continued viability of the demand requirement itself.

Petitioner rejects the force of these conclusions, grounding her approach on the extreme view that directors cannot be trusted to consider a complaint fairly or take appropriate action. This view no doubt nurtures petitioner's "concern" that all directors are lying in wait to quash shareholder complaints (*see* Pet. Br. 19-23). Petitioner's view speaks volumes as to why the futility exception has generated such a cottage industry of collateral litigation. If shareholder-plaintiffs and their counsel consider directors invariably untrustworthy, then it follows that they will consider demand to be invariably futile. Thus, shareholders (or their lawyers, as the court of appeals noted) rush to the courthouse to file suits, without first making a demand that might allow the matter to be resolved without litigation (*see* Pet. App. 13a).

Petitioner's view is fundamentally distorted because it ignores the vast changes that have occurred since the turn of the century in the ways in which corporations are regulated and corporate decisions are made. These developments have undercut any need for the futility exception as a safeguard against the possibility that a board of directors might fail to deal fairly with a shareholder demand. The impact of these

developments is particularly obvious here, where a substantial majority of the Fund's directors — seven out of 10 — are independent. There is no reasonable basis for presuming that these directors would not have fairly considered a demand, if petitioner had made one, or that petitioner would have lacked adequate remedies in that event.

The genius of the common law has been its capacity to adapt and meet the needs of a changing society. Thus, as Justice Cardozo has observed (B. Cardozo, *The Nature of the Judicial Process* 28 (1921) (emphasis in original)):

> [A judge] must first extract from the precedents the underlying principle, the *ratio decidendi*; he must then determine the path or direction along which the principle is to move and develop, if it is not to wither and die.

See also Business Elecs. Corp. v. *Sharp Elecs. Corp.*, 485 U.S. 717, 731-32 (1988).

The court of appeals correctly recognized that the time has come for the federal common law to confront the futility exception's corrosive effect on the demand requirement. This Court should adopt the rule articulated by the Seventh Circuit and thereby preserve the efficacy of the demand requirement.[24]

[24] Eliminating the futility exception in federal law cases does not conflict with the language of Rule 23.1 or in any way render the rule a nullity. Rule 23.1 implies the existence of situations in which a demand may be excused by providing that a plaintiff must allege with particularity that a demand was made or the reasons "for not making the effort." To understand the correct meaning of the latter phrase, however, one must remember that Rule 23.1 applies in all derivative cases brought in federal court, which includes actions under state statutory or common law (where demand might be excused) as well as those brought under federal law. Thus, the language of Rule 23.1 is broad enough to cover both types of cases. In addition, the phrase "for not making the effort" might cover cases involving demand on *shareholders*, *see Hawes*, 104 U.S. at 461, a matter not presented in this case.

(footnote continues)

III. BOTH COURTS BELOW PROPERLY RELIED UPON FEDERAL LAW.

In this Court, petitioner claims that federal law should not have been applied in this case, and that her allegations of futility should be evaluated under Maryland law (Pet. Br. 8-13). Petitioner's argument lacks merit for two reasons. First, petitioner never suggested the possibility that Maryland law might apply until her reply brief in the court of appeals. Even then, she affirmatively urged the court to apply federal law, rather than Maryland law, to the demand question. Thus, petitioner has waived any reliance on Maryland law.

Second, even if the issue had not been waived, the court of appeals was correct in holding that federal law is controlling. A uniform federal rule is required in this case because: (1) the demand requirement essentially is an exhaustion of remedies requirement, which is derived from federal common law, and does not directly involve the substantive powers of the board of directors; and (2) given the substantial federal regulation of mutual funds and their investment advisers, federal policy requires a uniform federal rule of law.

A. Petitioner Induced Both Courts Below To Apply Federal Law And Waived Any Argument That Maryland Law Applies.

Petitioner filed no pleading in the district court suggesting that Maryland law, rather than federal law, should govern the demand question. Everything filed by petitioner in the district court suggested that federal law should apply. For

(footnote continued)

At all events, Rule 23.1 was promulgated to effectuate administration of the demand requirement that this Court created in *Hawes*, and not to limit the Court's authority to adjust that requirement. *See Fox*, 464 U.S. at 543 (Stevens, J., concurring); *see also Mississippi Publishing Corp. v. Murphree*, 326 U.S. 438, 444 (1946) (addressing Rule 4(f), the Court stated that "[t]he fact that this Court promulgated the rules as formulated and recommended by the Advisory Committee does not foreclose consideration of their validity, meaning or consistency").

example, petitioner's amended complaint alleged that, given her allegations of futility, "application of a demand requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act" (Pet. App. 93a).[25]

Petitioner's opening brief in the court of appeals contained five pages of argument on the demand question (C.A. Br. 11-16). Petitioner did not argue that Maryland law should apply; on the contrary, she cited only two federal decisions applying federal law. The first mention of Maryland law appeared in her reply brief. Even there, petitioner asserted only that the court should not rely on any federal cases which interpreted Delaware law. In addition, she asserted that "if federal law is not applied, then the law of the state of incorporation governs the demand requirement" (C.A.R. Br. 10). Petitioner never argued that the district court improperly applied federal law. In these circumstances, the Seventh Circuit properly found that petitioner waived any argument that Maryland law should apply.[26]

[25] At no time did petitioner cite any legal authority in support of this assertion, which is incorrect in any event (*see* pp. 37-41, *infra*).

[26] There is no merit to petitioner's argument that KFS has waived the right to rely on petitioner's clear waiver of all choice of law issues because KFS's brief in opposition to the petition for writ of certiorari purportedly "did not suggest that consideration of Maryland law was barred because of lateness" (Pet. Br. 13). Petitioner's argument implies that her petition sought review on the theory that the Seventh Circuit applied federal common law when it should have applied Maryland law. This implication is false. Petitioner sought review in this Court on the theory that the Seventh Circuit's abolition of the futility exception conflicted with prior decisions of this and other federal courts (Pet. 5-12). In making that argument, petitioner merely noted that the Seventh Circuit had declined to "consider the impact of Maryland law" on waiver grounds (Pet. 8-9). However, petitioner did not raise the Seventh Circuit's failure to adopt Maryland law as a ground for granting review, and she did not begin to argue that Maryland law applied until her merits brief. The purported "error" was not assigned as a ground for this Court to grant review. Thus, there was no need for KFS to state

(footnote continues)

In holding that petitioner's argument came too late, the Seventh Circuit followed the neutral and established rule that federal appellate courts should not consider issues not raised and decided below. The courts of appeals uniformly have applied this rule, both as a general matter and with respect to choice of law issues in particular.[27]

Moreover, even if the courts below erred in applying federal law, that "error" was induced by petitioner and cannot now be urged as a basis for reversal, or even remand, of this case. *See, e.g., McPhail* v. *Municipality of Culebra*, 598 F.2d 603, 607 (1st Cir. 1979) (a party may not appeal from an error to which he contributed, either by failing to object or by affirmatively presenting the wrong law). *Accord Thunderbird, Ltd.* v. *First Fed. Sav. & Loan Ass'n*, 908 F.2d 787, 794 (11th Cir. 1990); *Brown* v. *Syntex Laboratories, Inc.*, 755 F.2d 668, 674 (8th Cir. 1985); *Director General of the India Supply Mission* v. *Steamship Maru*, 459 F.2d 1370, 1377 (2d Cir. 1972), *cert. denied*, 409 U.S. 1115 (1973).

Having asked the district court to apply federal law, petitioner had no right to object when the court did so. Nor did petitioner make that objection. Thus, neither petitioner nor the Commission may now raise that issue. This Court's consideration of that issue at this point would subvert settled and fundamental principles which are essential to the fair,

(footnote continued)

in its opposition that petitioner had waived the contention that Maryland law applied. For this reason, petitioner's citation (Pet. Br. 13) to Rule 15.1 is inapposite. The petition correctly stated that the court of appeals had deemed the choice of law issue to have been waived; hence, there were no "misstatements of facts or law" on this score that KFS was required to correct.

[27] *See Michigan Chem. Corp.* v. *American Home Assur. Co.*, 728 F.2d 374, 377 (6th Cir. 1984); *Reynolds* v. *American-Amicable Life Ins. Co.*, 591 F.2d 343, 344 (5th Cir. 1979); *Bilancia* v. *General Motors Corp.*, 538 F.2d 621, 623 (4th Cir. 1976) (per curiam); *Michael-Regan Co.* v. *Lindell*, 527 F.2d 653, 656 (9th Cir. 1975); *Pellerin Laundry Mach. Sales Co.* v. *Reed*, 300 F.2d 305, 309-10 (8th Cir. 1962).

just, and efficient administration of justice in the lower federal courts.

B. The Application Of Federal Law Is Proper Because Demand Is An Exhaustion Requirement That Is A Product Of Federal Common Law.

Even if petitioner had not waived her right to argue that Maryland law should apply, the courts below correctly chose to apply federal law. The demand requirement had its inception in *Hawes* as a rule created under federal common law to require a shareholder to "exhaust" intracorporate means of resolving disputes before coming to federal court. Because the demand requirement is itself a creature of federal common law, it necessarily follows that the parameters of this requirement — including the existence *vel non* of a futility exception — also must be determined under federal law.

The Commission concedes (SEC Br. 13) that federal law must govern the demand issue because the cause of action involved here arises under a federal statute. *See, e.g., Clearfield Trust Co.* v. *United States*, 318 U.S. 363, 366 (1943); *Burks*, 441 U.S. at 476; *Sola Elec. Co.* v. *Jefferson Elec. Co.*, 317 U.S. 173, 176 (1942). In this case, assuming that an independent right of action does exist under Section 20(a) (*see* p. 43, n.33, *infra*), it is a creature of federal statutory law. The scope of that federal right, and the conditions to be imposed upon its exercise, are federal questions governed by federal law.

However, petitioner and the Commission both contend (Pet. Br. 8-11; SEC Br. 14-16) that the case at bar implicates uniquely local concerns and requires, under the analysis in *Burks*, that state law be used as the federal rule of decision. This contention misconceives both the *Burks* analysis and the nature of the demand requirement.

In *Burks*, this Court was called upon to ascertain what law should apply in determining the standards to which a committee of independent directors should be held when it

seeks to terminate a derivative suit. 441 U.S. at 475. Noting that "state law . . . is the font of corporate directors' powers," the Court concluded that the issue of when directors' business judgment is entitled to preclude further litigation was an issue of corporate authority indisputably rooted in state law. Thus, the Court held that that issue should be resolved by reference to state law, unless that law conflicted with the federal regulatory scheme which gave rise to the cause of action. *Id.* at 478-80.

Neither the holding nor the reasoning of *Burks* is applicable here. Unlike *Burks*, this case does not involve the power of directors to dismiss and forever bar a derivative suit. The futility exception to the demand requirement does not deal with the power of directors, but with a prerequisite to filing suit in federal court.[28] Moreover, unlike the directors' right to dismiss a derivative suit, the demand requirement does not spring from "the font" of state law. In federal cases, the requirement that a demand be made on directors flows from *Hawes*, which was based on federal common law. Most assuredly, federal courts may set requirements for the filing in federal courts of derivative actions based on federal law.[29]

[28] This is in contrast to the question of demand on shareholders which, "unlike the demand on directors, is intertwined with the substantive law of corporations dealing with the power of shareholders to ratify 'fraud.'" 3B J. Moore, *Moore's Federal Practice* ¶ 23.1.19 at 94 (1990).

[29] Ignoring these critical distinctions, the Commission conclusorily announces that "*Burks* governs the issue of director demand" (SEC Br. 15). However, it would seriously misread *Burks* to suggest that simply because corporations are creatures of state law, every federal rule or requirement that in any way affects corporations necessarily must draw its meaning from state law.

Burks does not sweep so broadly. This Court's analysis did not end with the mere observation that corporations are creatures of state law, but instead focused on whether the particular rule at issue — in *Burks*, the right of directors to terminate litigation — found its source in state law. Finding that it did, the Court observed that state law would

(footnote continues)

Indeed, few matters are more federal in character than the power of the federal courts to fashion rules relating to the administration of proceedings before them, a principle that applies with particular force in federal question cases. Here, as in other contexts involving peculiarly federal interests, the paramount importance of a uniform federal common law rule is manifest. *See, e.g., Clearfield Trust*, 318 U.S. at 366-67 (rights and duties of United States concerning commercial paper); *West Virginia* v. *United States*, 479 U.S. 305, 308-09 (1987) (interest due for delayed payment of contractual obligation to United States). As this Court has stated in another context (*Hanna* v. *Plumer*, 380 U.S. 460, 472-73 (1965) (citation omitted)):

> One of the shaping purposes of the Federal Rules is to bring about uniformity in the federal courts by getting away from local rules. This is especially true of matters which relate to the administration of legal proceedings, an area in which federal courts have traditionally exerted strong inherent powers completely aside from the powers Congress expressly conferred in the Rules.

Although *Hanna* addressed the applicability of the federal rules in diversity cases, the principle that it confirms — that the administration of legal proceedings in a federal court is a matter with respect to which the importance of uniform rules is well-established — applies with even greater force to the exhaustion requirement involved here.

It cannot be the case that this Court, having created the demand rule as a matter of federal common law, is now powerless under that same common law to make adjustments needed to ensure the rule's continued viability. If that were

(footnote continued)

govern the rule unless it conflicted with the federal regulatory scheme under the 1940 Act. The Commission fails to acknowledge that the demand requirement does not stem uniquely from state law, but is rooted in the federal common law doctrine established in *Hawes*.

the case, federal law would be held hostage to — and perhaps be nullified by — whatever the 50 states variously may decide to do regarding a futility exception. This Court should reject the analysis offered by petitioner and the Commission, which would lead inexorably to this untenable result.

Moreover, application of the laws of the various states is singularly inappropriate because " 'their application would be inconsistent with the federal policy underlying the cause of action.' " *Burks*, 441 U.S. at 479 (citations omitted). Indeed, one need look no further than the Commission's *amicus curiae* brief in *Lampf Pleva Lipkind Prupis & Petigrow* v. *Gilbertson*, No. 90-333 ("*Lampf* Br."), to ascertain why the demand requirement must be governed by a uniform federal rule.

As the Commission stated in *Lampf*, there is a "federal interest in uniform and efficient enforcement of the securities laws throughout the Nation" because only federal law can "provide a promising source for a uniform, predictable rule" (*Lampf* Br. 4, 12). Applying the laws of 50 states rather than uniform federal law would result in " 'complex and expensive litigation over what should be a straightforward matter.' " *Agency Holding Corp.* v. *Malley-Duff & Assocs.*, 483 U.S. 143, 154 (1987) (citation omitted).

This federal policy, which the Commission correctly articulated in *Lampf*, is particularly strong in this case, which involves a fund operating under a federal statute which makes its directors "watchdogs." *Burks*, 441 U.S. at 484-85. Under the 1940 Act, Congress has mandated that a substantial percentage of these watchdog-directors be independent. 15 U.S.C. § 80a-10(a). A uniform federal law concerning demand is necessary to ensure that derivative litigation is allowed to proceed, but only in a way that does not usurp the watchdog role which Congress has conferred on the directors.

Thus, federal law must govern, so that "federal policy and the efficiency of litigation [will not be] impaired by the

borrowing of state law" (*Lampf* Br. 16-17). Only through application of federal law will the intent of Congress be realized, and the federal courts' prerogative to regulate the proceedings before them upheld.[30]

IV. THE CONTENTION THAT ALL SECTION 20(a) CLAIMS ARE DIRECT RATHER THAN DERIVATIVE, WHICH THE COMMISSION ALONE SEEKS TO ASSERT, NEVER HAS BEEN RAISED BY ANY PARTY AND IS NOT PROPERLY BEFORE THIS COURT.

The principal thrust of the Commission's *amicus curiae* brief (SEC Br. 7-13) is to invite this Court to ignore the opinions of both courts below and instead to decide this case on a ground that never has been raised in this case by any party, from the first day of this litigation to the present. The Commission asserts that because the Section 20(a) claim involves a proxy issue, it "is not subject to a requirement that the shareholder must make demand on the directors as a prerequisite to maintaining the action" (SEC Br. 7-8). For at least three reasons, this new issue, which is framed and urged only by the Commission, is not properly before the Court and should not be considered.

First, the Commission's new issue is not, under Rule 14.1, "fairly included" in the question upon which review was granted. The question states (Pet. i):

> As a prerequisite to bringing a shareholder action on behalf of an investment company to recover damages for proxy fraud under Section 20 of the Investment Company Act, must the shareholders first make a demand upon the company's directors to bring the action even where such a demand would be futile?

[30] Even if this Court should find state law applicable, the judgment should be affirmed because petitioner's allegations fail to meet the requirements of the futility exception even under Maryland law (*see* pp. 17-19, *supra*).

This question does not seek review as to whether a proxy claim can be asserted derivatively. Had petitioner sought review of that question, she would not have characterized the Section 20 claim as one "on behalf of an investment company." Nor would she have included the last phrase of her question presented, which undeniably refers to the futility exception.[31]

Indeed, the Commission admits (SEC Br. 8 n.5) that petitioner consistently and unequivocally pleaded the Section 20(a) claim as a derivative claim in the district court, and in the court of appeals expressly conceded that the claim was derivative by admitting the applicability of Rule 23.1. In this Court as well, petitioner never has argued that the Section 20(a) claim should be treated as a direct rather than a derivative action — not in her petition, not in her reply in support of the petition, and not in her merits brief. Petitioner's failure ever to raise this argument underscores that the Commission's new issue is not fairly included within the question presented for review.

Second, this Court has long recognized the compelling nature of those prudential considerations which counsel the Court to decline invitations to decide issues not raised or decided in the courts below. *See, e.g., DeShaney* v. *Winnebago County Dep't of Social Servs.*, 489 U.S. 189, 195 n.2 (1989). Those prudential considerations apply with special force where the new issue is raised only by an *amicus*. *United Parcel Serv.* v. *Mitchell*, 451 U.S. 56, 60 n.2 (1981); *Bell* v.

[31] The Commission itself has framed the question in the same way: "[w]hether a shareholder alleging a proxy violation under Section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), and seeking relief in favor of the investment company, is required by federal law to make a demand on the directors of the company to bring the action even when such a demand would be futile" (SEC Br. i).

Wolfish, 441 U.S. 520, 531-32 n.13 (1979); *Knetsch* v. *United States*, 364 U.S. 361, 370 (1960).[32]

Third, the Commission is incorrect in asserting that the Court should consider its new issue on the ground that it is "antecedent" to the question upon which this Court granted review (SEC Br. 8 n.5). At the threshold, it is curious that the Commission urges consideration of the allegedly "antecedent" question whether Section 20(a) claims ever may be derivative, without suggesting that the Court consider the more basic question whether Section 20(a) can support any implied right of action, derivative or direct.[33]

Moreover, if the concept of "antecedent" questions were as elastic as the Commission suggests, it would encompass virtually every legal question that could have been raised in a case. Few questions, if any, ever would be deemed waived. In addition, and contrary to first principles of appellate practice, the issues involved in litigation would become broader — not narrower — as a case proceeded through successive levels of appellate review. Indeed, that is the untoward result that petitioner and the Commission seek to accomplish in this case. (*See* pp. 8-9, *supra*.) At the very least, the idea that only jurisdictional issues are immune from waiver would become

[32] We have found only three occasions on which this Court has addressed issues which arguably were urged only by an *amicus*. *See Batson* v. *Kentucky*, 476 U.S. 79, 83-85 & n.4, 109 (1986); *Teague* v. *Lane*, 489 U.S. 288, 300 (1989); *Mapp* v. *Ohio*, 367 U.S. 643, 645-46 & n.3, 655 (1961). Unlike the case at bar, each of these cases involved constitutional issues. In addition, the issues decided in these cases had been raised below, or the questions presented by the parties were broad enough to encompass the grounds urged by *amici*.

[33] KFS argued below that where, as here, an action seeks only return allegedly excessive adviser fees, the exclusive remedy is Section 36(b). The district court rejected that argument (Pet. App. 39a-46a), and the Seventh Circuit found it unnecessary to reach (Pet. App. 7a). This Court has yet to decide whether any implied private right of action exists under Section 20(a), *Burks*, 441 U.S. at 475-76 & n.5, or how the specific remedy provided by Section 36(b) would affect any right of action that might be implied under Section 20(a).

a quaint remnant. If the Commission were correct, jurisdictional issues would be indistinguishable, as a practical matter, from a countless variety of other issues which also would be saved on the ground that they are "antecedent."[34]

At all events, the Commission's "antecedent" argument is based on a completely unwarranted premise. The Commission presumes that a proxy claim may never be a derivative action, and that questions of demand and futility should not therefore be reached. In turn, the notion that a proxy claim may never be a derivative action is premised on the Commission's erroneous view that a corporation never could bring a proxy claim (SEC Br. 7-8).

The Commission cites no case law, and we are aware of none, which holds that a proxy claim — whether under Section 20 of the 1940 Act or Section 14 of the 1934 Act — never may be brought by a corporation. Indeed, the Commission acknowledges that this Court in *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 431 (1964), recognized that implied rights of action for proxy violations may be derivative as well as direct (SEC Br. 12). As the Court stated in *Borak* (377 U.S. at 432):

> The injury which a shareholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the

[34] This Court frequently has refused to reach non-jurisdictional "antecedent" questions which have not been argued or decided below. One example is *Burks*, in which this Court assumed the existence of implied rights of action under the 1940 Act. The Court noted that "[t]he question whether a cause of action exists is not a question of jurisdiction, and therefore may be assumed without being decided." 441 U.S. at 476 n.5 (citations omitted). The prudential considerations counseling against deciding newly raised issues are so strong that even jurisdictional "antecedent" questions have been left for another day. *E.g.*, *United States* v. *Verdugo-Urquidez*, ____U.S.____, 110 S. Ct. 1056, 1064-65 (1990).

> corporation, rather than from the damage inflicted directly upon the shareholder.[35]

The Court rejected the argument that a private right of action under Section 14(a) "would not extend to derivative suits." *Id.* at 431. The Court reasoned that "[t]o hold that derivative actions are not within the sweep of the action would therefore be tantamount to a denial of private relief." *Id.* at 432.

The Commission fails to note that, consistent with *Borak*, corporations often have brought claims for proxy violations and that shareholders have brought such claims derivatively.[36] Indeed, that the proxy claim can belong to the corporation is underscored by the fact that courts have given

[35] The Commission asserts, *ipse dixit*, that the Court in *Borak* probably did not have in mind "true derivative actions," and suggests that, if it did, then the decision would not square with the "contemporary jurisprudence" reflected in *Fox* (SEC Br. 12 n.9). The Commission cites *Fox* for the proposition that "not all suits seeking a recovery for the benefit of the corporation qualify as derivative actions in the relevant sense" (SEC Br. 12-13).

The Commission's characterization ignores the fact that this Court in *Fox* did not address Section 20(a), but "the unusual cause of action created by § 36(b)." 464 U.S. at 535. Section 36(b) provides that such suits may be brought only by a shareholder or the Commission. Since the directors have no power to bring suit on behalf of the corporation, no purpose would be served by requiring a demand under Section 36(b). *See id.* at 542. By contrast, Congress did not confer the right to bring Section 20(a) claims only on certain parties. Thus, *Fox* cannot be read to suggest that a Section 20(a) claim could not be brought by a corporation.

[36] For example, in *King* v. *Kansas City Southern Indus.*, 56 F.R.D. 96 (N.D. Ill. 1972), *aff'd*, 519 F.2d 20, 26-27 (7th Cir. 1975), four mutual funds pursued actions under Section 20(a) alleging, among other things, that the defendants — including the investment adviser — had caused a misleading proxy to be sent to shareholders. The district court squarely recognized the right of the funds to pursue this action; indeed, the court denied a request by certain shareholders to litigate the case as a class action, and stayed proceedings on derivative actions filed by other shareholders. *56 F.R.D.* at 102.

(footnote continues)

res judicata effect to an earlier dismissal of the same Section 14(a) claim brought by another shareholder. In *Cramer* v. *GTE Corp.*, 582 F.2d 259 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979), for example, the court dismissed a proxy action brought by a second shareholder after an earlier shareholder action had been resolved, recognizing that "[a]lthough different shareholders brought the two actions, the actual plaintiff on whose behalf the claims were brought is the identical corporation, GTE." *Id.* at 267; *see also Gerrity* v. *Chapin*, 1980 WL 1364 (S.D.N.Y. 1980) (available on Westlaw).

In the case at bar, the Fund clearly could have considered the option of filing a proxy claim, if a demand had been made. The only injury alleged in the complaint is that the Fund was charged excessive fees (Pet. App. 91a). This alleged injury is one which would be suffered by all shareholders alike, according to their percentage ownership in the Fund. Petitioner did not allege that she suffered any injury separate and distinct from that suffered by all shareholders, and she sought no separate remedy. The only relief she specifically

(footnote continued)

Other cases also have recognized that, under *Borak*, proxy claims may be brought derivatively by shareholders or directly by the corporation itself. *See, e.g., Studebaker Corp.* v. *Gittlin*, 360 F.2d 692, 695 (2d Cir. 1966) (if Section 14(a) of the 1934 Act "authorizes a stockholder to assert such a [proxy] claim on the corporation's behalf, as held in Borak, it must also authorize the corporation to do so on its own"); *Management Assistance, Inc.* v. *Edelman*, 584 F. Supp. 1016, 1017 (S.D.N.Y. 1984) (Section 14(a) claim by corporation); *International Broadcasting Corp.* v. *Turner*, 734 F. Supp. 383, 385, 389-90 (D. Minn. 1990) (Section 14(a) claim by corporation); *Ameribanc Invs. Group* v. *Zwart*, 706 F. Supp. 1248, 1249 (E.D. Va. 1989) (Section 14(a) claim by corporation); *National Home Prods., Inc.* v. *Gray*, 416 F. Supp. 1293, 1297 (D. Del. 1976) (Section 14(a) claim by corporation against certain of its directors); *Lewis* v. *Anselmi*, 564 F. Supp. 768, 771-73 (S.D.N.Y. 1983) (derivative claim under Section 14(a)); *Lewis* v. *Valley*, 476 F. Supp. 62, 64 (S.D.N.Y. 1979) (derivative claim under Section 14(a)).

requested was that KFS be required "to pay to the Fund its damages" (Pet. App. 93a).[37]

As a practical matter, a corporation can pursue a number of other possible remedies to address an injury from an alleged proxy violation. However, a corporation's election of other remedies does not alter the fact that the proxy claim is a right "which properly may be asserted by it [the corporation]." Fed. R. Civ. P. 23.1. Demand is required to ensure that the corporation is afforded the opportunity to consider whether to sue or to pursue other options.[38]

In sum, the major premise of the Commission's so-called "antecedent" argument — that a corporation may never file a proxy claim — is untenable. Because this premise fails, so too does the Commission's "antecedent" argument. This Court therefore should decline the Commission's invitation to decide an issue which has never been litigated by the parties, or addressed or decided by the courts below.

[37] The Commission asserts that the relief sought does not determine whether a claim is derivative (SEC Br. 14-15). But the Commission ignores the fact that the relief sought typically reflects the nature of the injury suffered. And it is a "general precept of corporate law that a shareholder of a corporation does not have a personal or individual right of action for damages based solely on an injury to the corporation." *Gaff* v. *FDIC*, 814 F.2d 311, 315 (6th Cir.) (collecting authorities), *reh'g on other grounds*, 828 F.2d 1145 (1987); *see also* 12B Fletcher, *Cyclopedia of the Law of Private Corporations* § 5911 at 421 (1984) (footnote omitted) (an action is derivative "if the gravamen of the complaint is injury to the corporation"). It is equally clear that a depreciation or diminution in the value of a shareholder's stock is not the kind of "direct, personal injury which is necessary to sustain a direct cause of action." *Gaff*, 814 F.2d at 315 (citations omitted); 12B Fletcher, *Cyclopedia of the Law of Private Corporations* § 5911 at 421 (1984) (an action is derivative "if it seeks to recover assets for the corporation or to prevent the dissipation of its assets").

[38] As the foregoing discussion demonstrates, the Commission's new issue would not have warranted review by this Court even if it properly had been presented in a petition for a writ of certiorari. *See* Sup. Ct. R. 10.1.

CONCLUSION

For all of the foregoing reasons, the judgment of the court below, affirming the dismissal of petitioner's Section 20(a) claim, should be affirmed.

Respectfully submitted,

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Dated: February 19, 1991

APPENDIX

15 U.S.C. § 80a-2(a)(19)(B) provides in relevant part that:

> When used in this subchapter, unless the context otherwise requires . . . "Interested person" of another person means . . . when used with respect to an investment adviser of or principal underwriter for any investment company —
>
> (i) any affiliated person of such investment adviser or principal underwriter,
>
> (ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,
>
> (iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser or principal underwriter or by a controlling person of such investment adviser or principal underwriter,
>
> (iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,
>
> (v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and
>
> (vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

15 U.S.C. § 80a-10(a) provides that:

No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

15 U.S.C. § 80a-15(c) provides that:

In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as an investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

No. 90-516

In The

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

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POINT I

DIRECTORIAL ANTAGONISM EXCUSES DEMAND

In her main brief Petitioner pointed out (pp. 14-18) that the decisions of this Court establish that when a corporate directorate opposes a shareholder suit the futility of a demand by the shareholder is established. In *Delaware & Hudson Co. v. Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 451 (1909), this Court pointed out that "the good faith of the directors need not be questioned. . . . The attitude of the directors need not be sinister. It may be sincere." It is sufficient to excuse demand and comply with Rule 23.1 of the Federal Rules of Civil Procedure if it be alleged that the directors are "firm to resist appeals".

In *Smith v. Sperling*, 354 U.S. 91, 97 (1957), a majority of this Court held that "Whenever the management refuses to take action to undo a business transaction or whenever, as in this case, it so solidly approves it that any demand to rescind would be futile, antagonism is evident." The minority in *Smith v. Sperling* agreed that sincere opposition by the directors is sufficient to render demand futile. 354 U.S. 99, 110 (1957).

The opposing briefs, including those of the opposing *amici*, almost completely ignore these holdings. *Smith v. Sperling* is referred to but once, in a footnote to the brief of respondent Adviser ("KFS"), where the case is sought to be distinguished as dealing merely with diversity jurisdiction (p. 16 n. 12). By sweeping these authorities under the rug, KFS pretends that "this Court has never endorsed a futility exception," at least within the past sixty years. *Id.*, p. 30.

Respondents' desire to wish away this Court's holdings that directorial antagonism excuses demand is occasioned by the fact that directorial antagonism is abundantly present in this case. Contrary to the assertions of both respondents (KFS p. 15; Fund p. 9), the Fund in its initial answer opposed the proxy fraud claim on its merits. J.A. 27. KFS acknowledges (p. 15) that the directors asserted the belief that the proxy claim lacked merit. Additionally, the Fund concedes (p. 13) that the directors participated in the distribution of the proxy statement.

Respondents portray the allegations in ¶ 17(b) (92a) as reciting merely that the directors received compensation for serving as directors. However, that is not the case. The seven so-called "non-interested" directors serve as directors of all of the mutual funds in the Kemper Group, for which they receive aggregate remuneration of approximately $300,000 per year. This is far higher pay than would be received simply as serving as a director. Indeed, a director would have to attend all six board meetings during the year to receive approximately $5,820 if he were a director only of the Fund.[1] This would be appropriate directorial compensation. However, by serving as directors of all of the other mutual funds in the Kemper Group and receiving an aggregate of $300,000 per year, the directors, as it is alleged, are dependent upon and subservient to KFS. This is not, thus, simply a matter of being compensated for serving as a director, but of being beholden to management in the same manner as employees.

[1] 1984 Proxy Statement p. 4. KFS agrees in its brief (p. 2 n. 3) that the Proxy Statement may be judicially noticed.

As pointed out above, futility of demand is established by directorial antagonism, no matter how sincere. But even if respondents are correct that demand will be excused only upon a showing that the directors have a bias or antagonism so severe as to render them incapable of discharging their duties, that criterion is met in this case. The directors committed the very wrong complained of by distributing the false proxy statement. They have opposed the suit on its merits from the very beginning. By virtue of their extraordinarily large remuneration, they are financially dependent upon the Adviser. If, under these circumstances, state law, if otherwise deemed applicable, would nevertheless require a demand, then that requirement would be inconsistent with the federal policy underlying § 20 of the Investment Company Act and ought not to be enforced. We deal with that point below (Point IV).

POINT II

MARYLAND LAW EXCUSES DEMAND

Both respondents agree that Maryland law contains a futility exception. However, KFS seeks to distinguish the instant case from Maryland authority principally on the ground that the complaint herein does not use the word "fraud".

The contention borders on the frivolous. ¶ 13 of the Complaint alleges that the proxy statement "misleadingly described the fees" paid by a sister fund and "gave the false impression that the fees paid" by the sister fund were as high or higher than the fees paid by the Fund. 90a-91a. The directors were also directors of the sister

fund (92a) and thus knew that the fee structure was falsely represented. Accordingly, the Complaint asserts that any suit "brought to establish liability for the material false statements contained in that proxy statement would, if successful, tend to establish culpability and liability on the part of all of the directors of the Fund". ¶ 17(c), 93a. This is, of course, the very language of fraud, and is highly similar to the language contained in the complaint in *Parish v. Maryland & Virginia Milk Producers Association*, 250 Md. 24, 242 A.2d 512 (1968), *cert. denied*, 404 U.S. 940 (1971), as described in the opinion in that case.

In addition to the authorities cited in petitioner's main brief, *amicus* Investment Company Institute has cited the case of *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990), in which the Court held that the Maryland futility exception excuses demand even more readily than federal law.

POINT III

ABOLITION OF THE FUTILITY EXCEPTION IS UNCALLED FOR

Respondents also contend that the futility exception should be abolished. Here however, their paths diverge from those of their *amici*. The Business Roundtable opposes abolition of the futility exception at the federal level, stating that a universal demand rule would create a "procedural nightmare". Br. p. 5. The Investment Company Institute argues that elimination of the futility exception is warranted in cases arising under the Investment Company Act because of the regulatory controls to

which investment companies are subject. As we show below, the reasoning of the respondents and the Investment Company Institute is unsound and unsupportable by history, law or logic.

The principal argument which KFS makes in support of its plea to adopt a universal demand requirement is the development of special litigation committees. According to KFS (Br. p. 30), the use of special litigation committees is not a defensive reaction to shareholder inquests, but a device which "better insure[s] compliance" with corporate fiduciary standards. KFS maintains that special litigation committees are synonymous with public accountability; whereas, continuing its inversion of logic, it equates the excusing of demand where futile to a free-wheeling, laissez-faire approach to business and business entrepreneurs. *Id.*, pp. 29-30.

Adoption of a universal demand requirement, claims the respondent, will relieve the courts of "gobs of litigation" (*id.*, p. 22) and will promote intracorporate alternative dispute resolution, with the only cost to shareholders being "the inability to file or maintain suit." *Id.*, p. 27. It is, says KFS, the cynical views of shareholders such as petitioner which cause them to rush to the courthouse to file suits without first making a demand that might allow the matter to be resolved without litigation. *Id.*, p. 32.

But it is neither cynical nor speculative to predict that a universal demand requirement will spell the demise of shareholder derivative litigation. As the Court stated in *Joy v. North*, 692 F. 2d 880, 888 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983) (footnote omitted):

> As a practical matter, new board members are selected by incumbents. The reality is, therefore, that special litigation committees created to evaluate the merits of certain litigation are appointed by the defendants to that litigation. It is not cynical to expect that such committees will tend to view derivative actions against the other directors with skepticism. Indeed, if the involved directors expected any result other than a recommendation of termination at least as to them, they would probably never establish the committee.

Professor Dent, discussing the use of special litigation committees, states, "In no case known to the author have the directors agreed to sue." Dent, *The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 Nw. U. L. Rev. 96, 109 n. 70 (1980).

KFS contends that Petitioner's assessment is wide of the mark because the standard for judging the board decision not to sue will be that supplied by state corporate law, whatever that law may be. Br. p. 27 and n. 19. The Business Roundtable apparently acknowledges the validity of petitioner's concern if the board refusal were to be evaluated pursuant to the business judgment rule. Br. p. 21 n. 8. It quickly adds that the business judgment rule is the standard utilized under current law in cases in which demand is required. *Id.* In the so-called "demand excused" cases The Business Roundtable asserts that judicial review, at least in Delaware, is more favorable to plaintiffs. Br. pp. 18-19. But even there, as the *amicus* concedes, review is limited to the independence and good-faith of the special litigation committee coupled with a business judgment evaluation. *Id.* p. 19. Meritoriousness, if considered at all, takes a back seat. As

petitioner pointed out in her main brief (pp. 19-21 and n. 9), the utilization of special litigation committees thus imposes insuperable obstacles upon the plaintiff and burdens upon the judicial system.[2]

In a paradigm of circular logic KFS argues that it is not naive to assume that directors will promptly and forthrightly respond to a demand. If the directors do attempt to thwart action against them by appointing a special litigation committee, "shareholders will take action against" them. Br. p. 28 n. 20. Presumably with pitchforks.

In short, a universal demand requirement leads to a special litigation committee, which, ineluctably, leads to dismissal of the action, no matter how meritorious.

Amicus Investment Company Institute argues (Br. pp. 7-13) that, whatever the law with respect to other corporations, a universal demand requirement should apply to investment companies because of the statutory requirement that disinterested directors serve on the board. But as the SEC points out (Br. p. 19), it would be incongruous if the disinterested-director requirement, which attempts to compensate for special conflicts of interest in investment companies, actually diminished the rights that

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[2] The "gobs" of litigation to which the court of appeals and the respondent refer are highly imaginary. In fiscal 1990, out of 217,879 cases commenced in U.S. District Courts only about 1%, 2,442, were cases dealing with securities, commodities or exchanges; and only a small fraction of those – so small that the category is not broken out – were derivative actions. 1990 Annual Report of the Director, Administrative Office of the United States Courts III-14 – III-15.

shareholders in all other public companies enjoy. Moreover, although federal law mandates that disinterested directors serve on the board, it cannot and does not purport to guarantee that the disinterested directors will, as a factual matter in every instance, be able to act independently with respect to a particular transaction. For example, the Act does not address the possibility that a director who approved a transaction may be incapable of impartially evaluating whether the transaction violates federal law. Because the Act does not certify that a "disinterested" director is necessarily impartial in all instances, the futility exception does not conflict with the policy of the Investment Company Act.

The ICI's own arguments militate in favor of preserving the futility exception. The ICI correctly points out that Congress, in amending the Investment Company Act in 1970 to add § 36(b), stated that it wanted it to be understood that the section was not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. ICI Br. p. 11 n. 36, quoting from Senate Report No. 184. As petitioner pointed out in her main brief (pp. 27-28), one of the concepts which Congress wished to retain was the continued ability of shareholders to maintain private derivative actions. Thus, in *Tannenbaum v. Zeller*, 552 F.2d 402, 434 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977), the Court of Appeals held that "despite the repeated and extensive disclosures to the independent directors about recapture," a shareholder had the right to maintain an action for damages caused to the fund by proxy statements which failed to present that

subject to the shareholders.[3] *See also Papilsky v. Berndt*, 503 F.2d 554 (2d Cir.), *cert. denied*, 419 U.S. 1048 (1974) (denial of motion to dismiss shareholder's action under Investment Company Act for lack of demand on directors held not appealable). If the futility exception were truly at odds with the structure and requirements of the Investment Company Act, as the ICI contends, Congress would have said so and would not have repeatedly amended the Act while endorsing the implied private rights of action the courts had previously sustained.

Finally, the ICI contends that petitioner did not claim any injury due to the proxy fraud other than the excessive fees and in any event has no right of action under § 20(a) of the Act. It is well settled, however, that proxy claims and other rights of action under the securities law are cumulative, rather than exclusive of one another. See *SEC v. National Securities, Inc.*, 393 U.S. 453, 468-69 (1969) (proxy claim under § 14 of the Exchange Act may overlap with a claim under § 10(b) and Rule 10b-5). Moreover, the complaint does allege damage to the Fund and its shareholders as a result of the proxy fraud. Complaint ¶ 13, 91a. The damage occasioned by the proxy fraud is not

[3] At p. 6 n. 13 of its brief the ICI argues that section 36(b)(3) of the Investment Company Act precludes an action for damages against fund directors. In fact that section of the Act precludes an action for excessive advisory compensation against anyone other than the recipient thereof. It does not preclude an action against the directors for damages resulting from proxy fraud. Nevertheless, the insulation of the directors from liability for approving excessive compensation to the investment adviser reduces rather than increases the protection which shareholders might expect to receive from those directors.

measured by the same yardstick which is used in excessive advisory compensation cases under § 36(b). The latter class of cases depends largely upon profitability; *See, e.g., Krinsk v. Fund Asset Management, Inc.*, 875 F.2d 404 (2d Cir.), *cert. denied*, 110 S. Ct. 281 (1989). Proxy fraud, however, is subject to a somewhat different standard of measurement which starts with a determination of the impact upon the shareholders' vote; *see TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). In the present case, for example, the difference in fees falsely represented amounted to approximately $10 million per year (see petitioner's main brief p. 9).

The maintainability of shareholder proxy fraud cases was established at least as early as 1964 in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964), and applied to § 20 of the Investment Company Act in, *inter alia, Tannenbaum v. Zeller, supra*. A lengthy exposition is contained in the District Court's Opinion at 39a-46a, and will not be reiterated here. Suffice it to say that the contention that there is no private right of action under § 20 was not raised by any of the respondents either in the Court of Appeals or in this Court.

So far as we are aware the universal demand requirement has never been embraced by any court other than the court below. Its adoption would reverse over a century of careful and conservative adumbrations and refinements by this Court. The result would be a vast loss in investor protection which, in the long run, would prove detrimental to the ability of the capital markets to raise financing for American industry. No such radical departure should be endorsed by this Court.

POINT IV

IN THE FACTS OF THIS CASE IMPOSITION OF A DEMAND REQUIREMENT WOULD BE INCONSISTENT WITH THE FEDERAL POLICY UNDERLYING § 20 OF THE INVESTMENT COMPANY ACT

In *Burks v. Lasker*, 441 U.S. 471, 479-80 (1979), this Court held that the application of state law to directorial action concerning claims under the Investment Company Act would be countenanced unless the application of state law would be inconsistent with the federal policy underlying the cause of action.[4] Noting that hostile state rules would not be permitted to destroy federal rights, this Court cited, *inter alia, Levitt v. Johnson*, 334 F. 2d 815, 819-20 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965). In *Levitt* the Court of Appeals for the First Circuit refused to apply a Massachusetts rule which would have required demand upon shareholders in a derivative action seeking to enforce rights under the Investment Company Act. In reversing the dismissal of the action for failure to make such a demand, the Court of Appeals based its rationale upon the fact that the demand would be pointless because of the enormous obstacles which the plaintiff would face in attempting to convince a majority of the shareholders to endorse his action. Given the factual circumstances of the present case the inevitability of the outcome of a shareholder demand upon directors is equally manifest. A shareholder demand upon directors here faces no prospect of success, regardless of the merits of the underlying cause of action. Accordingly, insistence upon the demand would conflict with the Investment

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[4] *Burks* was an atypical derivative action in that no self-dealing was involved.

Company Act and must yield to that senior policy interest.

CONCLUSION

It is true that the typical large American corporation engages in thousands of transactions which are ordinarily the obligation of the corporate officers and its directorate to enforce or repudiate. Shareholder suits, however, are not concerned with those transactions. As The Business Roundtable concedes, virtually all derivative cases such as the present one involve allegations of self-dealing (Br. at 20 – 21). If there is to be any modification at all in this Court's solidly established rule that directorial opposition is alone sufficient to dispense with demand, let it be limited to those cases in which no conflict of interest is shown. Such a case was *Brooks v. American Export Industries, Inc.*, 68 F.R.D. 506 (S.D.N.Y. 1975), in which no potentially culpable defendant was a member of the corporate board of directors and the shareholder sought to preempt an action which the corporation was actually considering pursuing. Short of such an exceptional situation, however, the long-established jurisprudence of this Court, happily endorsed by the Congress, has well served the beneficial purposes of enforcing the federal securities laws and contributing to the policing of fiduciary responsibilities.

The Court of Appeals decision on the question presented for review is an aberration. It should be reversed and the case remanded for further proceedings.

Respectfully submitted,

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No. 90-516

In the Supreme Court of the United States

OCTOBER TERM, 1990

JILL S. KAMEN, PETITIONER

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.

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*ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT*

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether a shareholder alleging a proxy violation under Section 20(a) of the Investment Company Act, 15 U.S.C. 80a-20(a), and seeking relief in favor of the investment company, is required by federal law to make a demand on the directors of the company to bring the action even when such a demand would be futile.

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In the Supreme Court of the United States

OCTOBER TERM, 1990

No. 90-516

JILL S. KAMEN, PETITIONER

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is responsible for the administration and enforcement of the federal securities laws, including the Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq.* Private securities actions provide " 'a most effective weapon in the enforcement' of the securities laws and are 'a necessary supplement to Commission action.' " *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 310 (1985), quoting *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964). The standards governing demand requirements in shareholder deriv-

ative actions under the securities laws often have a significant impact on the disposition of those actions. The Commission has a strong interest, therefore, in the development of correct principles to govern such requirements.

STATEMENT

1. Petitioner Jill S. Kamen is a shareholder of respondent Cash Equivalent Fund, Inc. (Fund), a money market mutual fund registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq.* The Fund's investment adviser and manager is respondent Kemper Financial Services, Inc. (KFS). Petitioner filed a complaint on behalf of the Fund in the United States District Court for the Northern District of Illinois, alleging violations of two provisions of the Act by KFS. As amended, the complaint alleges that KFS charged the Fund excessive fees, in violation of Section 36(b) of the Act, 15 U.S.C. 80a-35(b). The complaint also alleges that KFS caused the Fund's directors to distribute a proxy statement, soliciting shareholder approval to continue the investment management agreement between KFS and the Fund, that was materially misleading in violation of Section 20(a) of the Act, 15 U.S.C. 80a-20(a).[1] Pet. App. 33a, 85a-93a.

Petitioner's proxy claim alleges that the proxy statement misleadingly compared the fees and services required under KFS's agreement with the Fund to those required under KFS's agreement with another fund for which it acted as manager, the Kemper Money Market Fund, Inc. (MM). According to the complaint, although the proxy statement accurately described the services rendered to the Fund and MM as being similar, it misleadingly described the fees charged to MM. The resulting impression, the complaint alleges, was that KFS's fees to MM

[1] Section 20(a) of the Act, 15 U.S.C. 80a-20(a), is virtually identical to the proxy provision of the Securities Exchange Act of 1934, Section 14(a), 15 U.S.C. 78n(a). Rule 20a-1 under the Act, 17 C.F.R. 270.20a-1, adopts the rules promulgated under Section 14(a) of the Exchange Act, 17 C.F.R. 240.14a-1.

were as high or higher than those to the Fund, when in fact KFS's fees to MM were substantially lower. The complaint further alleges that as a result of the misleading solicitation, the Fund's shareholders approved KFS's management agreement, thus causing damage to the Fund and its shareholders. As relief, the complaint requests the payment of damages to the Fund. Pet. App. 90a-91a, 93a.

The complaint also alleges that petitioner had not made a demand on the Fund or its directors to maintain the proxy action because demand would have been futile. In support of the assertion of futility, the complaint states that three of the ten directors had a personal financial interest in KFS; that the Fund's president had served as KFS's president and owned stock in its parent; and that the disinterested directors currently receive an aggregate of $300,000 annually for serving as directors of Kemper group funds. The complaint also asserts that the proxy statement was solicited by the Fund's directors, whose culpability would tend to be established if this suit were successful, and that demand would be tantamount to asking the directors to sue themselves. The complaint further alleges that KFS controlled the Fund and its directors, and that the directors and the Fund had manifested their opposition to the action by moving to dismiss the original complaint. Finally, the complaint alleges that requiring demand would be inconsistent with the policies underlying Section 20 of the Act. Pet. App. 86a, 92a-93a.

2. The district court dismissed the Section 20 claim on the ground that petitioner's allegations of the futility of demand failed to comply with the requirements of Rule 23.1 of the Federal Rules of Civil Procedure.[2] Pet. App. 46a-56a. Examining the complaint in light of fed-

[2] Rule 23.1 applies to shareholder derivative actions and requires a shareholder to allege "with particularity" his efforts, if any, to obtain the action desired from the directors, and "the reasons for the [shareholder's] failure to obtain the action or for not making the effort."

eral cases addressing the futility exception, the court concluded that petitioner did not particularize sufficient reasons for failing to make demand on the Fund's directors. Rather, petitioner's "generalized allegations" of futility "have been consistently rejected by the courts as inadequate under Rule 23.1." Pet. App. 51a.[3]

3. The court of appeals affirmed the dismissal of petitioner's proxy claim.[4] Although agreeing with the district court that petitioner's allegations of futility were inadequate, Pet. App. 6a, 17a, the court of appeals went on to formulate a new rule, as a matter of federal common law, that demand on directors is a universal requirement in cases in which shareholders bring derivative actions under a federal statute; futility never excuses demand. *Id.* at 20a. The court said: "[C]laims of futility should be tested by *making* the demand rather than by arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law." *Ibid.*

In explaining its holding, the court acknowledged that it is theoretically correct that demand should be excused if the courts would not honor the board's decision not to sue. But the court observed that in practice it is difficult to resolve contested claims that demand would be a futile gesture. Pet. App. 14a-15a. Claims of futility, the court thought, are hotly contested because of the principle embraced by some States that when a shareholder makes a demand, review of the board's decision not to sue is conducted under the highly deferential business judgment standard. *Id.* at 12a. The court rejected

[3] The court also dismissed petitioner's claim under Section 36(b) of the Act, on the basis that petitioner was not an adequate class representative. Pet. App. 73a-77a, 79a, 84a.

[4] It reversed the dismissal of petitioner's Section 36(b) claim, Pet. App. 22a-29a, but rejected her request for a jury trial. *Id.* at 29a-32a. Because the grant of certiorari is limited to the first question presented by the petition, no issue under Section 36(b) is before this Court.

that principle, however, concluding that "when the demand requirement comes from federal common law, the making of a demand does not affect the standard with which the court will assess the board's decision not to sue." *Id.* at 13a. Having "sever[ed] the link between demand and the standard of review," the court concluded that the difficulties in determining whether demand is futile "are not worth incurring." *Id.* at 14a.

In formulating these principles, the court declined to consider whether proxy claims are properly characterized as derivative actions at all for purposes of Rule 23.1, because that point had not been raised by petitioner. Pet. App. 6a-7a. The court also noted that it could be argued that demand requirements should be drawn from state corporate law, but it declined to consider that argument because petitioner did not rely on the law of Maryland, where the Fund is incorporated, until filing her reply brief. *Id.* at 8a-9a. Finally, the court recognized that Supreme Court decisions from the early years of the century arguably established a federal futility exception to the demand requirement. *Id.* at 18a, citing *Doctor* v. *Harrington*, 196 U.S. 579 (1905); *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R.*, 213 U.S. 435, 447 (1909). But the court of appeals concluded that those decisions had either been overruled sub silentio, or were out of step with contemporary developments in corporate law; accordingly, the court concluded that neither case prevented it from abandoning the futility exception as a matter of federal common law. Pet. App. 20a.

SUMMARY OF ARGUMENT

A. A claim that a misleading proxy statement was used to solicit shareholder votes is a direct shareholder action that does not implicate the requirement of demand applicable to derivative actions. The essence of a derivative action is the shareholder's assertion, on behalf of the corporation, of a legal claim that the corporation has against the directors, officers, or third parties. The demand requirement exists in such cases to preserve the primacy of corporate directors in managing the enterprise's affairs. But where the underlying claim belongs directly to shareholders, demand is not necessary. Cf. *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984). That is the situation in this case.

Petitioner's action asserts a violation of the *shareholders'* right to receive truthful and complete information about questions presented to shareholders for a vote. It follows from the purpose of federal proxy regulation —to protect the shareholders' right to honest disclosure— that a shareholder's proxy action does not assert a claim that belongs to the corporation. Accordingly, the demand requirement, and the body of principles designed to determine when demand is excused, does not apply in this context.

B. On the assumption that a demand requirement is at issue here, the court of appeals erred in formulating a universal demand requirement as a matter of federal common law, thus abolishing any exception for cases in which demand would be futile. The issue in this case is governed by *Burks* v. *Lasker*, 441 U.S. 471 (1979), which held that rules establishing the powers of corporate directors are generally drawn from state law, unless those rules are inconsistent with federal policy. *Burks* involved a core issue of corporate law—the power of disinterested directors to terminate derivative litigation. Here too, the issue of demand on directors is a core issue of corporate law that should be controlled, absent a conflict with federal policy, by state law.

The law of Maryland, the State of the Fund's incorporation, recognizes a futility exception to the demand requirement. Nothing in the policy of the Investment Company Act is inconsistent with a futility exception. Although the Act creates disinterested directors who serve a valuable watchdog function in investment companies, no federal policy is frustrated by excusing demand on a board of directors when it would be futile.

The court of appeals' federal demand requirement is also objectionable on its own terms. Not only would it complicate the selection of state rules applicable to the directors' efforts to terminate derivative actions, it could dilute the standards under which those efforts are reviewed by the courts, contrary to federal policy. Those difficulties provide added reasons for adhering to the approach of *Burks* v. *Lasker* of borrowing state law on internal corporate affairs unless federal policy requires otherwise.

ARGUMENT

THE COURT OF APPEALS ERRED IN FORMULATING A UNIVERSAL DEMAND REQUIREMENT AS A MATTER OF FEDERAL COMMON LAW

A. Shareholder Allegations Of Proxy Violations Are Properly Characterized As Direct Actions

Before applying any demand requirement, the threshold inquiry is whether a particular claim is a derivative action within the meaning of Rule 23.1 of the Federal Rules of Civil Procedure. The rule applies to "a derivative action brought by one or more shareholders * * * to enforce *a right of a corporation* * * *, the corporation * * * having failed to enforce a right which may properly be asserted by it[.]" Fed. R. Civ. P. 23.1 (emphasis added). In our view, a shareholder's proxy suit asserts a legal claim belonging to the shareholder himself, and is not subject to a requirement that the share-

holder must make demand on the directors as a prerequisite to maintaining the action.[5]

1. Shareholder derivative actions originated in equity as the consolidation of two distinct claims: first, the claim by a shareholder that the corporation has failed to assert a corporate right, and, second, the claim by the corporation against the directors, officers, or third parties who are liable to it. See *Hawes* v. *Oakland*, 104 U.S. 450, 452 (1882); *Ross* v. *Bernhard*, 396 U.S. 531, 534-535 (1970); *Aronson* v. *Lewis*, 473 A.2d 805, 811 (Del. 1984); 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* §§ 5941.1, 5946 (1984 rev. ed. & Supp. 1990); Block, Radin & Rosenzweig, *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 Bus. Law. 469, 470-471 (1990). Because the purpose of the action is to allow shareholders to protect corporate rights, "[t]he heart of the action is the corporate claim." *Ross* v. *Bernhard*, 396 U.S. at 539. See *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 528-529 (1984); *Cohen* v. *Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949) (in a derivative action, the shareholder steps into the corporation's shoes and seeks in its right "the restitution he could not demand in his own"); *Meyer* v. *Fleming*, 327 U.S. 161, 167 (1946) (derivative suit "enforce[s] a corporate claim * * * where the management * * * declines to take the proper and necessary steps to assert the rights which the corporation has").

[5] Petitioner's complaint alleges that her action is brought on behalf of the Fund, Pet. App. 86a, and she conceded the applicability of Rule 23.1 in the court of appeals. Consequently, that court noted but did not address the issue whether the action is properly treated as direct in nature. Pet. App. 7a. Although the petition does not challenge the applicability of Rule 23.1, the question presented is framed broadly enough to encompass that issue, see Sup. Ct. R. 14.1(a), and the Court has discretion to address it as an "antecedent" question that is "ultimately dispositive of the present dispute." *Arcadia* v. *Ohio Power Co.*, 111 S. Ct. 415, 418 (1990).

The demand requirement is integrally tied to the character of a derivative action as the assertion of a corporate claim. It reflects the principle that the management of the corporation is entrusted to its directors, not its shareholders. As the Court explained in *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors[.]" Directors, exercising business judgment, "may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right." *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903), see also *Ashwander* v. *TVA*, 297 U.S. 288, 343 (1936) (Brandeis, J., concurring); *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R.*, 213 U.S. 435, 446 (1909).

But the purposes of the demand requirement define the limits of its application. For example, if the corporation is not authorized to assert a particular cause of action, shareholders need not make a demand on the directors to do so. In *Daily Income Fund, Inc.* v. *Fox*, *supra*, the Court applied that principle, holding that the provisions of Rule 23.1 are inapplicable to a claim by a security holder under Section 36(b) of the Investment Company Act, 15 U.S.C. 80a-35(b), that an investment adviser has breached its fiduciary duty with respect to the receipt of compensation from the company. The Court explained that Section 36(b) expressly authorizes security holders and the SEC to enforce such claims, but does not authorize the investment company itself to do so. Since the claim is not one that the company could assert, it is not a derivative action under Rule 23.1. 464 U.S. at 534-542. An analogous principle applies if the cause of action arises not from the invasion of the corporation's legal rights, but from the invasion of the shareholders' legal rights. In

that setting, the cause of action is not "derived from the corporation," *Cohen* v. *Beneficial Loan Co.*, 337 U.S. at 549, and is not properly subject to its control. Cf. *Smith* v. *Sperling*, 354 U.S. 91, 99 (1957) (Frankfurter, J., dissenting) (contrasting derivative action from the "wholly different situation * * * which arises when the corporation is charged with invasion of the stockholder's independent right").

2. In light of those principles, a shareholder's claim based on a proxy violation is a direct action that does not implicate the requirement of demand. A proxy claim asserts a violation of a shareholder's own right to truthful and complete information in communications used to solicit his vote. Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a)—the original provision in the securities laws regulating the solicitation of proxies—was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which [had] frustrated the free exercise of the voting rights of stockholders." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934). The provision's purpose is to guarantee that persons soliciting proxies will provide "an explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934). See *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 431 (1964); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970). In 1940, Congress likewise empowered the SEC to prescribe proxy-solicitation rules for investment companies "as necessary or appropriate in the public interest or *for the protection of investors*." 15 U.S.C. 80a-20(a) (emphasis added). See S. Rep. No. 1775, 76th Cong., 3d Sess. 17 (1940).

It follows from the purpose of federal proxy regulation that when a shareholder's vote is secured through a false or misleading proxy statement, it is the personal right of the shareholders to "[f]air corporate suffrage" that is violated. H.R. Rep. No. 1383, *supra* at 13. When the

shareholder sues to vindicate that right, the action asserts a direct infringement of federal requirements enacted for his benefit; the claim does not "derive" from an invasion of legal rights belonging to the corporation. Accordingly, the conceptual underpinning for requiring demand in a derivative case—that the right in question belongs to the corporation—is absent.[6]

It would be deeply ironic if directors could secure the shareholders' votes through a misleading proxy statement, and then insist that a shareholder seeking redress make demand on the directors before suing. Cf. *Galef* v. *Alexander*, 615 F.2d 51, 63 (2d Cir. 1980) (purposes of the proxy provision "would quite clearly be frustrated" if a director sued for proxy violations "were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation").[7] Even if the directors could not obtain the outright dismissal of a proxy claim in all instances when the shareholder did not make demand, the demand requirement would impose an unwarranted procedural hurdle with potential delay and additional costs that would obstruct the shareholders' assertion of their right to truthful proxy statements.

Characterizing a proxy claim as a direct action does not deprive directors of means to oppose a suit they believe to be contrary to the shareholders' interests.[8] The

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[6] The corporation may also bring a proxy claim in certain circumstances, but in such a case, the claim is properly viewed as deriving from a violation of the shareholders' rights. See *Piper* v. *Chris-Craft Indus., Inc.*, 430 U.S. 1, 32 & n.21 (1977).

[7] In *Galef*, the Second Circuit held that federal policy precludes defendant directors in a Section 14(a) action from summarily dismissing that claim pursuant to the business judgment rule. 615 F.2d at 64; see *id.* at 64 n.20 (reserving the issue of whether a committee of disinterested directors could, consistent with federal policy, terminate a proxy suit on business judgment grounds).

[8] Nor does it prevent investment company directors from fulfilling their statutory duties. Although the Act requires disinterested

corporation is frequently named as a nominal defendant in proxy litigation to obtain complete relief, and, where it is not, it may intervene as a party under the customary standards for intervention. In that capacity, the corporation may urge that the complaint lacks merit, or that the relief sought would not be "in the best interests of the shareholders as a whole." Cf. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. at 388.

Nor should the type of relief sought by a shareholder's proxy action affect the analysis. To be sure, a proxy action may loosely be called derivative—"in the broad sense of that word"—if it seeks a monetary recovery in the corporation's favor. See *Fox*, 464 U.S. at 535 n.11. Indeed, in *J. I. Case Co.* v. *Borak*, 377 U.S. at 431, the Court described the implied private right for proxy violations as including derivative as well as direct claims.[9] That description reflects the hybrid aspect of a proxy action like petitioner's: the action asserts a violation of shareholder rights, but seeks recovery for the benefit of the corporation.[10] But, as *Fox* illustrates, not all suits

directors who serve as "watchdogs" for investors, see *infra* at 19, nothing in the Act or its policies empowers those directors to control direct shareholder actions.

[9] The Court has since made clear that the cause of action recognized in *Borak* flows from the violation of all of the shareholders' rights, and that "[t]he *Borak* Court was thus focusing on all stockholders—the owners of the corporation—as the beneficiaries" of the proxy provision. *Piper* v. *Chris-Craft Indus., Inc.*, 430 U.S. at 32 & n.21. *Borak*'s characterization of the action before it as "derivative" did not rely on the factors governing whether an action is considered derivative under traditional concepts, see *Hawes* v. *Oakland*, 104 U.S. at 460, or contemporary jurisprudence, see *Daily Income Fund, Inc.* v. *Fox, supra*. Above all, nothing in *Borak* indicates that the Court had in mind the corporate management issues underlying the demand requirement as applied to true derivative actions. At most, the *relief* authorized by *Borak* is derivative; the underlying claim is not. Cf. *Mills*, 396 U.S. at 388 (discussing "derivative" relief).

[10] Of course, a particular proxy action may seek direct damages to be paid to the shareholder plaintiffs, and have no element that could be viewed as derivative. See, *e.g.*, *Virginia Bankshares, Inc.* v. *Sandberg*, No. 89-1448 (argued Oct. 9, 1990). Other actions may simultaneously seek, as alternative relief, the direct payment of damages to shareholders and other forms of relief for the corporation's benefit. See *Mills*, 396 U.S. at 388-389. A rule distinguishing proxy claims by the form of relief sought, requiring demand for some but not for others, would produce nothing but confusion.

seeking a recovery for the benefit of the corporation qualify as derivative actions in the relevant sense. "[T]he provisions [of Rule 23.1] regarding demand assume a lawsuit that could be controlled by the corporation's board of directors." *Fox*, 464 U.S. at 533. When the legal claim could not properly be controlled by the board, the rules developed to protect the directors' primacy in overseeing corporate affairs do not apply.

B. Demand and Futility Requirements For Shareholder Derivative Actions Under The Investment Company Act Should Be Drawn From State Law

On the assumption that petitioner's action is viewed as a derivative one that implicates the demand requirement, the court of appeals erred in its novel formulation of a federal demand rule. Asserting the power to make federal common law, the court of appeals imposed a universal demand requirement in all derivative actions arising under a federal statute, thereby eliminating the traditional exception for futility. In our view, the court of appeals should not have confronted the demand question armed solely with federal common law, without initial consultation of state corporate law. In this case, as in *Burks* v. *Lasker*, 441 U.S. 471 (1979), state law furnishes the applicable rule unless it conflicts with federal policy.

1. *State law supplies the demand requirements applicable to federal derivative actions, unless state requirements are inconsistent with federal policy*

Because petitioner's cause of action arises under a federal statute, federal law governs the incidents of the action; "state law does not operate of its own force." *Burks*

v. *Lasker*, 441 U.S. at 480; *Sola Elec. Co.* v. *Jefferson Elec. Co.*, 317 U.S. 173, 176 (1942); *D'Oench, Duhme & Co.* v. *FDIC*, 315 U.S. 447, 471-472 (1942) (Jackson, J., concurring). But federal law may look to state sources to derive the appropriate rule of decision, particularly in an area in which the States enjoy primary responsibility. See *Reconstruction Finance Corp.* v. *Beaver County*, 328 U.S. 204, 210 (1946) (applying state property law); *De Sylva* v. *Ballentine*, 351 U.S. 570, 580 (1956) (applying state domestic relations law). The substantive law of corporations belongs to this category. Although federal principles may, "where the facts require[], control the appropriateness of redress despite the provisions of state corporation law," *J. I. Case Co.* v. *Borak*, 377 U.S. at 434, "the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law." *Burks*, 441 U.S. at 478. See *Cort* v. *Ash*, 422 U.S. 66, 84 (1975); cf. *Milwaukee* v. *Illinois*, 451 U.S. 304, 313-314 (1981).

In *Burks* v. *Lasker*, the Court considered which law—state or federal—applies when an independent committee of directors seeks to terminate a shareholder's derivative claim under the Investment Company Act.[11] 441 U.S. at 475. The Court held that the issue should be resolved by applying a two-step analysis. *First*, because "[c]orporations are creatures of state law * * * and it is state law which is the font of corporate directors' powers," that body of law should be consulted as an initial matter. *Id.* at 478. Federal law for corporations, the Court explained, "is largely regulatory and prohibitory in nature—it often limits the exercise of directorial power, but only rarely creates it." *Ibid.* Consequently, "congressional legislation is generally enacted against the background of existing state law" which is not displaced "simply because a plaintiff's cause of action is based upon a federal statute." *Ibid.* *Second*, a court must determine whether state law permits action that is prohibited by federal law or is inconsistent with underlying federal policy; if it does, federal policy prevails. *Id.* at 479. This " 'consistency' test guarantees that '[n]othing that the state can do will be allowed to destroy the federal right.' " *Id.* at 480, quoting *Board of County Comm'rs* v. *United States*, 308 U.S. 343, 350 (1939).[12]

The analysis in *Burks* governs the issue of director demand in this case. The demand requirement, like the authority of disinterested directors to terminate derivative litigation, expresses a policy with respect to the management of a corporation's internal affairs. The pre-

[11] In *Burks*, shareholders of an investment company filed a derivative action against the company's directors and its investment adviser, alleging that the defendants had breached their duties under the Act and the common law by purchasing a particular issuer's commercial paper without making an adequate independent investigation of its quality and safety. 441 U.S. at 473-474. In response to the action, the board appointed a quorum of independent directors to determine the company's position in the case. Following an investigation, the committee determined that the suit was contrary to the shareholders' interest, and sought its dismissal. *Id.* at 474. The court of appeals held that the Investment Company Act deprived disinterested directors of the power to terminate such derivative litigation. *Id.* at 475. This Court reversed, holding that federal law had a narrower sweep. *Id.* at 480-485.

[12] The approach marked out in *Burks* contrasts with the approach for choosing between state and federal law in selecting a statute of limitations for a federal claim that lacks an express limitations period. See SEC Amicus Brief, *Lampf Pleva Lipkind Prupis & Petigrow* v. *Gilbertson*, No. 90-333 (to be argued Feb. 19, 1991) (arguing that a five-year federal limitations period should be applied to implied actions under Rule 10b-5). (We have provided copies of our brief in *Lampf* to the parties here.) The different test prescribed in *Burks* can be explained as a response to the characteristic relationship between state and federal law in corporate matters: federal law generally imposes restrictions on internal management, rather than providing "the source of authority for managerial power." 441 U.S. at 478. In contrast, there is no similar division of responsibilities between the state and federal governments in devising statutes of limitations.

eminent reason for requiring demand is to further "a principle basic to corporate organization, that the management of the corporation be entrusted to its board of directors." Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976); *Hawes* v. *Oakland*, 104 U.S. at 462; *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. at 530. Demand may also serve to stimulate alternative dispute resolution, to allow the corporation to assert the derivative claim directly, and to discourage "strike" suits. See D. DeMott, *Shareholder Derivative Actions: Law and Practice* § 5:03, at 26-27 (1987); Block, Radin & Rosenzweig, *supra*, at 472-473; *Aronson* v. *Lewis*, 473 A.2d 805, 811-812 (Del. 1984); 13 W. Fletcher, *supra*, § 5963. Each of those reasons reflects substantive policy choices about the internal management of corporate affairs. Indeed, in the law of some States, the demand requirement is interwoven with the power of disinterested directors to terminate derivative litigation. See *Spiegel* v. *Buntrock*, 571 A.2d 767 (Del. 1990). Accordingly, state requirements with respect to demand, which are found in the law of every State, see D. DeMott, *supra*, § 5:03, at 23, should be given effect in federal derivative litigation in the absence of a conflict with federal policy.[13]

Rule 23.1 of the Federal Rules of Civil Procedure does not require courts to fashion a body of federal law to

[13] As this Court noted in *Fox*, 464 U.S. at 530-531, the demand requirement that was established as a matter of federal common law in *Hawes* v. *Oakland*, *supra*, and later codified in Equity Rule 94, 104 U.S. ix-x (1882), served the additional purpose of preventing the collusive manufacture of diversity jurisdiction. That policy, along with other policies designed to reduce federal court adjudication of state claims, continues to be reflected in Rule 23.1. *Fox*, 464 U.S. at 531 n.6. But the major purpose of the demand requirement is to promote substantive policies regarding the litigation of corporate claims. *Id.* at 532-533; *id.* at 544 n.2 (Stevens, J., concurring) ("It cannot be doubted that [the demand] requirement, designed to improve corporate governance, is one of substantive law.").

govern demand.[14] On its face, the Rule does not establish a specific requirement of demand, but simply requires that "[t]he complaint shall * * * *allege* with particularity the efforts, *if any*, made by the plaintiff to obtain the action the plaintiff desires from the directors * * * and the reasons for the plaintiff's failure to obtain the action *or for not making the effort*" (emphasis added). The Rule does not discuss the consequences of omitting to make demand, nor does it address when, if ever, demand is excused. Its purpose is to establish a pleading requirement, with substantive standards to be supplied from another source. *Starrels* v. *First Nat'l Bank*, 870 F.2d 1168, 1170 (7th Cir. 1989). Indeed, construing Rule 23.1 to create substantive standards for demand would conflict with the Rules Enabling Act, 28 U.S.C. 2072, which provides that rules of civil procedure may not "abridge, enlarge or modify any substantive right." See *Mississippi Publishing Corp.* v. *Murphee*, 326 U.S. 438, 445-446 (1946); *Sibbach* v. *Wilson & Co.*, 312 U.S. 1, 14 (1941); cf. *Bangor Punta Operations, Inc.* v. *Bangor & A. R.R.*, 417 U.S. 703, 708 n.4 (1974).[15]

[14] In *Fox*, the Court reserved this issue of whether Rule 23.1 establishes a demand requirement as a matter of federal procedure. 464 U.S. at 532 n.8; see also *id.* at 543-544 (Stevens, J., concurring) (arguing that Rule 23.1 "concerns itself solely with the adequacy of the pleadings; it creates no substantive rights").

[15] As the court of appeals noted (Pet. App. 18a-20a), this Court developed a demand requirement, and exceptions to it, in a line of cases decided before *Erie R.R.* v. *Tompkins*, 304 U.S. 64 (1938). Whether or not those cases can be distinguished as the court of appeals suggested—and whether, after *Erie*, they carry weight apart from their persuasive force, see *Clearfield Trust Co.* v. *United States*, 318 U.S. 363, 367 (1943)—our essential point is this: this Court's decision in *Burks* v. *Lasker*, *supra*, makes clear that those early decisions do not control the analysis of what is required, in a federal action, with respect to core issues of corporate law such as demand. Likewise, we do not believe that the court of appeals was justified in overlooking state law because the issue was not raised until the reply brief. The court evidently appreciated the relevance

2. *Maryland law, which excuses demand when it would be futile, is not inconsistent with the policy of the Investment Company Act*

Applying the approach established in *Burks*, the first step is to select a body of state law. Here, the relevant law is that of Maryland, the State in which the Fund is incorporated. See *CTS Corp.* v. *Dynamics Corp.*, 481 U.S. 69, 89 (1987). Maryland law does not require that demand be made in all derivative actions; rather, it embodies a traditional exception that demand is excused if it would be futile. See *Parish* v. *Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 81-84, 242 A.2d 512, 544-545 (1968).[16]

The second step is to measure the requirements of state law against federal policy. In our view, nothing in the Act overrides Maryland's recognition of a futility exception to making demand. To begin with, the Act contains no express provision requiring shareholders to make demand on the directors prior to bringing a derivative action. In contrast, Congress created a demand requirement for actions under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), and made Section 16(b) applicable to closed-end investment companies.[17] 15 U.S.C. 80a-29(f). Cf. *General Motors Corp.*

of *Burks* in this context, and at the very least should not have crafted a generally applicable rule of federal common law on the basis of a procedural peculiarity of the case before it.

[16] Currently, the majority of investment companies are organized in Maryland or Massachusetts. Massachusetts, like Maryland, recognizes a futility exception. See *Houle* v. *Low*, 407 Mass. 810, 813 n.3, 556 N.E.2d 51, 53 n.3 (1990). We express no view on how Maryland applies its futility exception; that issue is one for the lower courts. Compare *Burt* v. *Danforth*, 742 F. Supp. 1043, 1047-1049 (E.D. Mo. 1990) (finding that Maryland futility exception excuses demand more readily than federal law) with *Zimmerman* v. *Bell*, 585 F. Supp. 512, 514 (D. Md. 1984) (treating Maryland and federal futility exceptions as equivalent).

[17] Section 16(b) provides that a shareholder may bring an action in behalf of the issuer to recover certain short-swing profits "if the

v. *United States*, 110 S. Ct. 2528, 2532 (1990). Nor is Maryland's recognition of a futility exception inconsistent with the policies of the Act. Indeed, it would be anomalous to conclude that the Act's policies impose greater restrictions on investment company shareholders than are imposed on other shareholders in publicly held companies, as the Act was intended to fortify, not undermine, shareholder protection. See 15 U.S.C. 80a-1(b)(2).

The Act does rely heavily on disinterested directors to protect shareholder interests, see *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. at 536-537; *Burks* v. *Lasker*, 441 U.S. at 470-471. But that reliance does not imply a requirement of universal demand. The Act requires that 40% of the company's board consist of independent directors who are neither "affiliated" nor "interested" persons as defined in the Act, 15 U.S.C. 80a-2(a)(19), 80a-10(a), and entrusts those directors with a variety of responsibilities, including the review and approval of the investment adviser and principal underwriter's contracts, 15 U.S.C. 80a-15(c), the appointment of directors to fill certain vacancies, 15 U.S.C. 80a-16(b), and the selection of the company's outside auditor, subject to shareholder ratification, 15 U.S.C. 80a-31(a).

But "[a]ttention must be paid as well to what Congress did *not* do." *Burks*, 441 U.S. at 483. Although Congress intended the independent directors to serve as "'watchdogs' to protect shareholder interests," *id.* at 485, it did not give directors absolute power; rather, Congress also gave shareholders an important voice in company affairs. It is particularly relevant to the proxy claims here that the Act requires the initial investment advisory agreement to be approved not only by the disinterested direc-

issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter." See also *Cramer* v. *General Tel. & Elec. Corp.*, 582 F.2d 259, 276 n.22 (3d Cir. 1978) (board's decision not to sue does not preclude subsequent shareholder action), cert. denied, 439 U.S. 1129 (1979).

tors, but also by "the vote of a majority of the [company's] outstanding voting securities." 15 U.S.C. 80a-15(a) and (c). In addition, the Act identifies several significant business changes that cannot be made without a similar level of shareholder approval. 15 U.S.C. 80a-13(a).[18] Indeed, in the critical area of policing against fiduciary breaches by the investment adviser involving compensation, Congress determined to rely exclusively on shareholders and the SEC, not the disinterested directors, to bring suit to safeguard shareholder interests. 15 U.S.C. 80a-35(b); *Fox*, 464 U.S. at 534-535. These inroads on what would normally be management prerogatives reveal that Congress did not intend to leave the protection of shareholder rights entirely in the hands of the disinterested directors. Rather, Congress carefully strengthened the role of disinterested directors in certain quite specific ways, and limited the board's authority in others. It is reasonable to assume that where Congress did not see fit to act, the background rules of state corporate law ordinarily continue to operate.

In our view, no policy found in the statutory scheme dictates a displacement of the traditional futility exception by a universal demand requirement. The law of Maryland, like that of most other jurisdictions, recognizes that demand generally fulfills valuable corporate purposes, but occasionally plays no useful role in regulating derivative claims. It is not necessary to further the policies of the Act that Maryland law be supplanted by a federal rule.

[18] These include a change in classification from a diversified to a nondiversified company; the borrowing of money, issuance of senior securities, or purchase or sale of commodities or real estate not in accordance with the company's registration statement; the deviation from policy with respect to investment in an industry or group of securities as set forth in the registration statement, or from any policy deemed fundamental by the company (see 15 U.S.C. 80a-8(b)(3)); or the cessation of being an investment company. 15 U.S.C. 80a-13(a)(1) to (4).

3. *The court of appeals' federal demand requirement is unworkable, and, if not properly restricted, could infringe shareholder rights under the Investment Company Act*

The court of appeals purported to formulate a federal universal-demand requirement after "sever[ing] the link between demand and the standard of review" applied to the directors' decision not to sue. In so holding, the court expressed its disagreement with those States that treat the making of demand as having significant consequences for the standard of review. Pet. App. 12a-14a, 20a. But the court's attempt to liberate the demand requirement from the subsequent course of derivative proceedings gives rise to perplexing and unresolved complications. Moreover, the application of a universal demand requirement could, in certain cases, undermine investor protection. Both of those considerations counsel strongly against adoption of the court of appeals' sharp break with state law.

a. In the law of most States, the demand requirement does not exist in isolation; it is part of a larger web of principles for determining when directors can obtain the dismissal of a derivative claim. The law of Delaware well illustrates the interdependence of principles in this area. In Delaware law, there are two categories of derivative cases: those in which demand is required, and those in which it is excused.[19] In "demand required" cases, if a shareholder files a derivative action after the board has rejected his demand, the board's refusal to sue is tested under the deferential standards of the business judgment rule. Under those standards, the board's rejection of de-

[19] Demand is excused if "under the particularized facts alleged," the complaint creates "a reasonable doubt" that "(1) the directors are disinterested and independent" or that "(2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson* v. *Lewis*, 473 A.2d at 814; *Pogostin* v. *Rice*, 480 A.2d 619, 624 (Del. 1984). See Block, Radin & Rosenzweig, *supra*, at 475-480.

mand "will be respected unless it was wrongful." *Zapata Corp.* v. *Maldonado*, 430 A.2d 779, 784 (Del. 1981). The shareholder must carry the burden of establishing facts to overcome the directors' decision.[20] In "demand excused" cases, however, an entirely different standard applies. After the shareholder initiates the derivative action, the board is not ousted of power to terminate it; although self-interested directors cannot act for the board, disinterested directors may still express the corporation's viewpoint that the suit should be dismissed. *Id.* at 785-786.[21] But if disinterested board members make that determination, their decision is tested against a dual standard: (1) the directors must shoulder the burden of establishing the independence and good faith of their committee, and the reasonableness of its investigation, and (2) the court has discretion to apply its independent business judgment to determine whether dismissal of the action is in the corporation's best interest. *Id.* at 788-789; *Kaplan* v. *Wyatt*, 499 A.2d 1184, 1192 (Del. 1985).[22]

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[20] Delaware cases state that, where applicable, the business judgment rule protects director decisions absent "gross negligence," and that the directors' decision will be honored "[a]bsent an abuse of discretion." *Aronson* v. *Lewis*, 473 A.2d at 812 & n.6.

[21] The usual mechanism is for the board to delegate authority to a committee of distinterested directors, who investigate the claim with the advice of counsel, and determine the corporation's position. This was the approach employed in *Burks* v. *Lasker*.

[22] Delaware's approach has also been followed by several federal courts applying state law. See *Rosengarten* v. *Buckley*, 613 F. Supp. 1493, 1499-1500 (D. Md. 1985) (Maryland law); *Peller* v. *Southern Co.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,714, at 98,311 (N.D. Ga. 1988) (Georgia law); *Abella* v. *Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 797-800 (E.D. Va. 1982) (Virginia law). See also *Joy* v. *North*, 692 F.2d 880, 891 (2d Cir. 1982) (construing Connecticut law to adopt Delaware's approach, but also requiring independent review in a demand-excused case of the merits of the decision not to sue), cert. denied, 460 U.S. 1051 (1983); *Alford* v. *Shaw*, 358 S.E.2d 323, 327-328 (N.C. 1987) (following Delaware approach, but also requiring court to evaluate independently in all cases the merits of decision not to sue). In contrast, several jurisdictions have adopted procedures providing for less extensive judicial review of the decision not to pursue the suit. See, *e.g.*, *Auerbach* v. *Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Gaines* v. *Haughton*, 645 F.2d 761, 770-772 (9th Cir. 1981) (applying California law), cert. denied, 454 U.S. 1[illegible] (1982). The law is in a state of flux in this field. See D. DeMott, *supra*, §§ 5:04 to 5:06.

The creation of a universal demand requirement, as a matter of federal law, undercuts the application of Delaware's two-tier regime. At best, the elimination of the demand-excused category would be a source of confusion about how to apply that branch of Delaware law. If demand is made and rejected, is the applicable standard the business judgment rule or the *Zapata* two-part test? Does the standard depend on whether demand would have been excused under Delaware law? And who bears the burden of proof? Delaware law supplies no answers to those questions. It eliminates the possibility that a shareholder who makes demand may still assert that demand was excused; if demand is made, the business judgment rule applies. *Spiegel* v. *Buntrock*, 571 A.2d 767, 777 (1990). The federal universal-demand requirement disregards that "the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability." *Aronson* v. *Lewis*, 473 A.2d at 812.

At worst, the newly minted federal standard would operate to undermine settled state precedents, in needless tension with the holding of *Burks* v. *Lasker*. Under *Burks*, the authority of disinterested directors to terminate derivative litigation is governed by state law, absent inconsistency with federal policy. But if courts are unable to identify the applicable state rule—as may well happen after a shareholder complies with a federal universal demand requirement—they would necessarily end up improvising new rules to fit particular cases. Not only would that run counter to *Burks*, it also clashes with the chief objective of the Seventh Circuit's rule: to simplify deriva-

tive litigation. Rather than ushering in an era of simplicity, the court of appeals' rule bids fair to entangle derivative suits in a protracted process of searching for rules to bridge the gap between state and federal requirements.

b. The court's universal demand requirement could also have troubling, and, in our view, impermissible, consequences for the enforcement of claims under the Investment Company Act. Although the court of appeals purported not to determine the standard for reviewing the board's decision not to sue after a shareholder makes demand, the court seemed to endorse the view that all litigation decisions by disinterested directors would be reviewed under the deferential standards of the business judgment rule. Pet. App. 10a-11a, 15a, 17a.

The directors' opinion that a derivative action is inimical to the shareholders' best interests may be perfectly valid; the costs of pursuing a particular corporate claim may outweigh the benefits. But the standards for reviewing that determination must be consistent with the purpose of the Investment Company Act to protect shareholders against conflicts of interest by corporate directors. 15 U.S.C. 80a-1(b)(2). The precise standards that should govern are not at issue here, and are a matter covered by state law in the first instance. But we believe that in certain circumstances, shareholders must be able to pursue suits on behalf of their companies even when directors object. See *Burks*, 441 U.S. at 481 ("[P]otential conflicts may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser."). Simplifying the law of demand is an admirable goal, but it is not a goal that justifies compromising the ability of shareholders to protect themselves, and the corporation, from improper transactions resulting from conflicts of interest.[23]

[23] If, contrary to our submission, the Court embraces some formulation of a federal universal-demand requirement, we urge the Court to make clear that its holding does not dictate application of the business judgment rule, or any particular standard, in reviewing the directors' decision. That issue need not be reached in this case, since no director decision is at issue, and it should be left for another day.

c. The difficulties with the court of appeals' holding—both in accommodating the federal demand requirement to the surrounding legal rules derived from state law, and in avoiding undue infringement of investor protection —flow from a single source: the court's departure from the framework of analysis established by *Burks* v. *Lasker*, *supra*. State law governing shareholder derivative actions may be subject to criticism on policy grounds, as the court of appeals thought. Nevertheless, if inadequacies in policy require an overhaul of corporate governance rules, the proper bodies to address that issue, if federal law has not done so, are the legislatures and courts of the States.[24] *Burk's* approach "relieves federal courts of the necessity to fashion an entire body of federal corporate law out of whole cloth." 441 U.S. at 480. This case illustrates the wisdom and vitality of that approach.

* * * * *

Petitioner's proxy claim is properly characterized as a direct action that is not subject to a requirement of demand. Alternatively, if a demand requirement does

[24] The American Bar Association and the American Law Institute have each proposed model corporate law codes that provide for universal demand, but differ as to the appropriate standard of judicial review. The ABA recommends that refusal of demand be reviewed under a business judgment standard, with the burden of proof shifting to the corporation if a majority of the board is not independent. See *Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings*, 45 Bus. Law. 1241 (1990). The ALI, in contrast, allows independent judicial review of the board's decision, whether or not a majority is independent. *Principles of Corporate Governance: Analysis and Recommendations* §§ 7.08, 7.10, 7.11 (Tent. Drafts Nos. 8 & 9, 1988 & 1989), reproduced at Block, Radin & Rosenzweig, *supra*, at 501-503. The Commission takes no position on these recommendations.

apply here, Maryland's recognition of a futility exception to demand is controlling. In our view, the initial examination of Maryland law, and its application to petitioner's allegations, should be undertaken by the courts below. Cf. *Burks* v. *Lasker*, 441 U.S. at 486; *United States* v. *Kimbell Foods, Inc.*, 440 U.S. 715, 740 (1979).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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No. 90-516

IN THE

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR THE BUSINESS ROUNDTABLE AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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Dated: February 19, 1991

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No. 90-516

In the Supreme Court of the United States

OCTOBER TERM, 1990

JILL S. KAMEN,

PETITIONER,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

RESPONDENTS.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

MOTION OF THE BUSINESS ROUNDTABLE FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

The Business Roundtable hereby moves for permission to file the accompanying brief *amicus curiae* in support of respondents in this action.

The Business Roundtable is an association of 200 major corporations, represented by their chief executive officers. The Roundtable was founded in 1972, in the belief that business executives should take an increased role in public policy debates. Since 1972, the Roundtable has issued a series of frequently cited white papers regarding important corporate governance issues, including *Statement of The Business Roundtable: The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus.

Law. 2083 (1978), *Statement of The Business Roundtable on Corporate Responsibility* (1981), *Statement of The Business Roundtable on the American Law Institute's Proposed 'Principles of Corporate Governance and Structure: Restatement and Recommendations'* (1983), and, most recently, *Statement of The Business Roundtable: Corporate Governance and American Competitiveness*, 46 Bus. Law. 241 (1990).

The issue before this Court concerns the pre-litigation demand requirement. This requirement is a substantive rule of law that ensures that shareholder derivative actions do not "undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984). As an association including many of the corporations upon whose behalf shareholder derivative litigation is purportedly brought and as an association whose members are the parties most directly affected by this form of litigation, The Business Roundtable has an important interest in (and an important perspective regarding) the rules governing the initiation of such litigation.

The Business Roundtable believes that the case before the Court presents two important questions that have not been fully briefed in this action by the parties: (1) whether state law governs the substantive law of demand underlying Federal Rule 23.1's procedural requirement, and (2) if this Court determines that federal law governs the demand issue, whether the "universal" demand requirement adopted by the court of appeals should be rejected due to the tremendous uncertainty and confusion for the courts litigants which would be created between a *federal* universal demand requirement and the *state* corporate law issues that would surround such a requirement.

Counsel of record for petitioner has refused to consent to the filing of this brief because counsel does not believe that there are questions in the case which require further briefing. Counsel of record for petitioner reached this determination without reviewing the draft of this brief that was offered by The Business Roundtable, and refused to discuss the issue with counsel for The Business Roundtable. Counsel of record for respondents has consented to the filing of this brief.

Respectfully submitted,

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Dated: February 19, 1991

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ON WRIT OF CERTIORARI TO THE
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**BRIEF FOR THE BUSINESS ROUNDTABLE
AS *AMICUS CURIAE*
IN SUPPORT OF RESPONDENTS**

INTEREST OF THE BUSINESS ROUNDTABLE

The Business Roundtable is an association of 200 major corporations, represented by their chief executive officers. The Roundtable was founded in 1972, in the belief that business executives should take an increased role in public policy debates. Since 1972, the Roundtable has issued a series of frequently cited white papers regarding important corporate governance issues, including *Statement of The Business Roundtable: The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083 (1978), *Statement of The Business Roundtable on*

Corporate Responsibility (1981), *Statement of The Business Roundtable on the American Law Institute's Proposed 'Principles of Corporate Governance and Structure: Restatement and Recommendations'* (1983), and, most recently, *Statement of The Business Roundtable: Corporate Governance and American Competitiveness*, 46 Bus. Law. 241 (1990).

The issue before this Court concerns the pre-litigation demand requirement. This requirement is a substantive rule of law that ensures that shareholder derivative actions do not "undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984). As an association including many of the corporations upon whose behalf shareholder derivative litigation is purportedly brought and as an association whose members are the parties most directly affected by this litigation, The Business Roundtable has an important interest in (and an important perspective regarding) the rules governing the initiation of such litigation.

SUMMARY OF ARGUMENT

The Business Roundtable submits this brief in support of the *result* reached in favor of respondents Kemper Financial Services, Inc. and Cash Equivalent Fund, Inc. in the District Court for the Northern District of Illinois (reported at 659 F. Supp. 1153) (Pet. App. 33a-60a) and the Court of Appeals for the Seventh Circuit (reported at 908 F.2d 1338) (Pet. App. 1a-32a). Both of these courts dismissed petitioner's claim under section 20(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-20(a), due to petitioner's failure to make a pre-litigation demand.

The Business Roundtable, however, disagrees with the reasoning utilized by the courts below. Both the district court and the court of appeals began with the premise that the substantive rules underlying the pre-litigation demand requirement are governed by federal law. The district court then dismissed the action because petitioner had not pleaded particularized facts demonstrating that demand should be excused as futile under federal law, and the court of appeals —while noting its agreement with the district court regarding the insufficiency of plaintiff's demand futility allegations—dismissed the action pursuant to a new "universal" demand requirement mandating demand in all cases involving federal claims, without regard for traditional notions of demand futility.

A. This Court has repeatedly held that "[c]orporations are creatures of state law," and that state law governs the powers of corporate directors unless the application of state law permits an action that is inconsistent with federal policy. *Burks v. Lasker*, 441 U.S. 471, 478-79, 486 (1979). The pre-litigation demand requirement plainly implicates the power of corporate directors to make decisions regarding the management of the business and affairs of corporations, such as the initiation of litigation proposed by minority shareholders, and is therefore governed by state law unless that state law is contrary to federal policy. Federal Rule 23.1 does not render the demand requirement an issue of federal law, because that Rule "does not require a demand, it only requires that the complaint allege with particularity what demand if any has been made. . . . [T]he Rule concerns itself solely with the adequacy of the pleadings; it creates no substantive rights." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 543-44 (1984) (Stevens, J., concurring).

B. The relevant state's law is that of Maryland because respondent Cash Equivalent Fund, Inc. is a Maryland corporation. Under Maryland law, as in most states, a pre-litigation demand is required unless a shareholder pleads particularized facts demonstrating that the role of the corporation's directors (or the alleged domination and control of the directors by alleged wrongdoers) is such that demand would be "futile." Petitioner's allegations in this case are plainly insufficient to excuse demand under Maryland law, and no

federal policy is inconsistent with the imposition of such a demand requirement. Indeed, this Court held in *Burks* that no federal policy prohibits termination by disinterested directors under state law of shareholder actions brought pursuant to the Investment Company Act. *A fortiori*, no federal policy prohibits states from requiring a pre-litigation demand prior to a shareholder's filing of such a suit, or from excusing that demand where a demand would be "futile."

C. If this Court holds that federal law governs the pre-litigation demand requirement in this case, then the Court should reject the "universal" demand requirement adopted by the court of appeals, and affirm the dismissal of this action on the ground relied upon by the district court–petitioner's failure to plead particularized facts demonstrating demand futility under federal law. Requiring demand in all cases admittedly may produce beneficial corporate governance results, such as assuring directors a pre-litigation opportunity in all cases to examine shareholder grievances and take corrective action where appropriate, and saving litigants and courts the time and expense they would otherwise incur in litigating the demand futility issue.

Demand, however, is only one of many issues involved in derivative litigation, most of which–including what happens when a demand is refused–are indisputably state law issues under *Burks*. Requiring demand on a universal basis *as a matter of federal law* would plague the federal courts (and the litigants in these courts) with tremendous uncertainty and confusion, due to the close relationship between a *federal* universal demand requirement and the *state* corporate law issues that would surround such a requirement. Federal courts faced with board refusals of universal demands would be required to develop *de novo* state law standards upon which board refusals of demand would be evaluated. This endeavor would be embarked upon without the guidance of state court precedents, since, so long as there is no universal demand requirement in a particular state (and, to date, only three states–Florida, Georgia and

Michigan–require a universal demand), there can be no law in that state regarding board refusals of such a universal demand.

These state law issues which will arise in the future, of course, need not–and should not–be decided on the record before this Court, which includes neither a demand nor a refusal of a demand. The existence of these state law issues, however, demonstrates that the adoption of a universal demand rule at the federal level would create a procedural nightmare for the federal courts, leading to less predictability and more litigation than is the case under current law–a result which will far outweigh any benefits which might be achieved by adopting a federal universal demand requirement. The issue is thus best left to the states, to be decided upon in conjunction with all other state law corporate governance issues.

ARGUMENT

THE JUDGMENT OF THE COURT OF APPEALS SHOULD BE AFFIRMED BECAUSE A PRE-LITIGATION DEMAND IS REQUIRED UNDER THE GOVERNING STATE LAW

A. State Law Governs The Substantive Law Of Demand Underlying Federal Rule 23.1's Procedural Requirement Unless State Law Is Inconsistent With Federal Policy

This Court has held time and time again that "[c]orporations are creatures of state law." *Burks v. Lasker*, 441 U.S. 471, 478 (1979) (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977), and *Cort v. Ash*, 422 U.S. 66, 84 (1975)). State law thus provides "the font of corporate directors' powers," and is "the first place one must look to determine the powers of corporate directors."

Burks, 441 U.S. at 478. *See also CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) ("[n]o principle of corporate law and practice is more firmly established than a State's authority to regulate domestic corporations").

This Court has also held that the *only* circumstance in which state law will not control the powers of corporate directors regarding the internal affairs of a corporation is where state law permits an action that is inconsistent with federal policy. In such cases, federal policy prevails. *Burks*, 441 U.S. at 478-79, 486. *See also Santa Fe*, 430 U.S. at 479 and *Cort*, 442 U.S. at 84 ("investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation") (emphasis in *Santa Fe*, but not *Cort*).

It is the law in virtually every state today that "[a] decision whether or not a corporation will sue an alleged wrongdoer is no different from any other corporate decision to be made in the collective discretion of the disinterested directors." *Burks*, 441 U.S. at 487 (Stewart, J., concurring) (citing *Swanson v. Traer*, 354 U.S. 114, 116 (1957), *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), and other cases). *See also, e.g.*, *Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990) ("A basic principle of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation. . . . The decision to bring a law suit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation."); *Houle v. Low*, 407 Mass. 810, 821, 556 N.E.2d 51, 57 (1990) ("the decision whether to sue is properly left to the corporate authorities"); R. Clark, *Corporate Law* § 15.2, at 641 (1986) ("Whether to sue or not to sue is ordinarily a matter for the business judgment of directors, just as is a decision that the corporation will make bricks instead of bottles.").

Therefore, prior to filing a shareholder derivative action, a shareholder generally must demand that the corporation's board of directors cause the corporation to pursue the alleged claim.

This pre-litigation demand requirement serves several important purposes. First, and most prominently, the requirement reflects the fundamental tenet of corporate law described above: The business and affairs of corporations, including decisions regarding litigation, are managed by or under the direction of directors, and not by individual shareholders.

Second, the demand requirement "enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation." *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). The requirement thus "serves the interests of judicial economy since a demand may often result in corrective action short of suit and, thereby, not only relieve the courts from entanglement in the management of internal corporate affairs, but also protect them from vain rulings on challenged acts which are later ratified by the board." *Barr v. Wackman*, 36 N.Y.2d 371, 378, 329 N.E.2d 180, 185-86, 368 N.Y.S.2d 497, 504-05 (1975). *See also Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984) (demand requirement requires that a shareholder "exhaust his intracorporate remedies," and thus promotes "alternate dispute resolution, rather than immediate recourse to litigation").

Third, the demand requirement "affords corporate directors reasonable protection from the harassment of litigious dissident shareholders who might otherwise contest decisions on matters clearly within the directors' discretion," *Barr*, 36 N.Y.2d at 378, 329 N.E.2d at 186, 368 N.Y.S.2d at 504-05, and thereby discourages "strike suits" brought "not to remedy wrongs to the corporation, but to induce settlements beneficial to the named plaintiff or his counsel." *Cramer*,

582 F.2d at 275. *See also Aronson*, 473 A.2d at 812 (demand requirement "provide[s] a safeguard against strike suits"); *Barr*, 36 N.Y.2d at 378, 329 N.E.2d at 185-86, 368 N.Y.S.2d at 505 (demand requirement is "designed to discourage 'strike suits' by shareholders making reckless charges for personal gain rather than corporate benefit").

In light of these important purposes underlying the demand requirement, Justice Stevens observed in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984), that "[i]t cannot be doubted that this type of requirement, designed to improve corporate governance, is one of substantive law." *Id.* at 544 n.2 (Stevens, J., concurring). *See also, e.g., Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1166 (Del. 1989) (the demand requirement is a "stricture[ ] of substantive law," and not a "mere formalit[y] of litigation").

The court of appeals recognized that "the demand requirement is an aspect of the division of authority between corporate managers and investors, a division usually governed by state law," that "*Burks* holds that federal law with respect to directors' power to dismiss derivative suits should be derived from state law, unless the state law is hostile to federal interests," and that "[p]erhaps the demand requirement, too, should be absorbed from state law." 908 F.2d at 1342 (Pet. App. 8a). The court of appeals nevertheless declined to decide whether the source of the demand requirement was state law or Federal Rule 23.1, because, until the filing of plaintiff's reply brief in the court of appeals, both parties had assumed that federal law governed the issue. *Id.* The Business Roundtable respectfully submits that the parties and the court of appeals erred by simply assuming that a procedural rule such as Federal Rule 23.1 could provide the

source of the demand requirement.[1]

Rule 23.1 provides (in relevant part) *only* that a derivative complaint in a federal action must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." As Justice Stevens stated in *Daily Income*, Rule 23.1 is nothing more than a procedural rule requiring that the plaintiff in a derivative action must:

> allege the facts that will enable a federal court to decide whether such a demand requirement has been satisfied; *Rule 23.1 is not the source of any such requirement*. The plain language of the Rule

1. Numerous federal courts have similarly "assumed that the federal procedural rule establishes both the pleading guidelines as well as the substantive contours of the underlying demand requirement." *Gaubert v. Federal Home Loan Bank Bd.*, 863 F.2d 59, 63 (D.C. Cir. 1988). *See, e.g., Sax v. World Wide Press, Inc.*, 809 F.2d 610, 613 (9th Cir. 1987); *Lewis v. Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1209-10 (9th Cir. 1980); *In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). The trend since this Court's 1979 decision in *Burks*, however, has been either application of state law, *see, e.g., Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1170 & n.4 (7th Cir. 1989); *First Am. Bank & Trust v. Frogel*, 726 F. Supp. 1292, 1298 (S.D. Fla. 1989); *Washington Bancorp. v. Washington*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,893, at 94,885 (D.D.C. Sept. 26, 1989), or deferral of the issue on the ground that the results obtained by applying state and federal law are the same. *See, e.g., Gaubert*, 863 F.2d at 64; *Jordan v. Bowman Apple Prods. Co.*, 728 F. Supp. 409, 413 (W.D. Va. 1990); *Lou v. Belzberg*, 728 F. Supp. 1010, 1016 n.1 (S.D.N.Y. 1990); *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1116 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985).

The Business Roundtable urges the Court to reach this choice of law issue despite petitioner's failure to raise the issue until the eleventh hour, because of the importance of the issue, the uncertainty surrounding the issue, and the tremendous resources being devoted to the issue by litigants and the courts.

makes that perfectly clear; *the Rule does not require a demand, it only requires that the complaint allege with particularity what demand if any has been made on the corporation. . . . Thus the Rule concerns itself solely with the adequacy of the pleadings; it creates no substantive rights.*

Daily Income, 464 U.S. at 543-44 (Stevens, J., concurring) (emphasis added).[2]

This construction of Rule 23.1, Justice Stevens also noted in *Daily Income*, is consistent with the Rules Enabling Act, which provides that general rules of practice and procedure—such as the Federal Rules of Civil Procedure—may not "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2072. In Justice Stevens' words, "there is substantial doubt whether [Rule 23.1] could create [a substantive demand requirement] consistent with the Rules Enabling Act. Since the Rule does not clearly create such a substantive requirement by its express terms, it should not be lightly construed to do so and thereby alter substantive rights." 464 U.S. at 544 n.2 (Stevens, J., concurring) (citing *Mississippi Publishing Corp. v. Murphree*, 326 U.S. 438, 445-46 (1946), and *Sibbach v. Wilson & Co.*, 312 U.S. 1, 14 (1941)).

Finally, a very important practical reason mandates application of state law in federal court actions involving the pre-litigation demand requirement. Were different rules ap-

2. *See also, e.g., Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1170 (7th Cir. 1989) ("The issue . . . is whether the . . . complaint states with particularity (federal procedural requirement under Rule 23.1) facts which would excuse a demand upon the directors as futile under Delaware corporate law (substantive state law)."); *In re BankAmerica Sec. Litig.*, 636 F. Supp. 419, 421 (C.D. Cal. 1986) ("the substantive law of the state of incorporation should govern whether demand is sufficient or excused"; "federal law should determine whether the plaintiffs' demand or excuse has been pled with particularity sufficient to meet the requirements of the Federal Rules of Civil Procedure").

plied in federal and state court on the demand issue, a plaintiff who could plead diversity or pendent jurisdiction, or who had a federal cause of action which did not grant exclusive jurisdiction to federal courts (such as, for example, the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, and the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961 *et seq.*), could shop for whatever forum offered him the most favorable demand requirement. As the court noted in *Allison v. General Motors Corp.*, 604 F. Supp. 1106 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985):

> It would be disquieting if a derivative plaintiff suing a Delaware corporation could achieve a different answer as to whether demand is excused as futile simply by filing, quite literally, 'across the street' in Chancery Court.

Id. at 1116 n.11.[3]

State law should accordingly govern the pre-litigation requirement, *unless* the demand requirement established by state law is inconsistent with federal policy.

B. State Law—In This Case Maryland Law—Mandates Dismissal Of This Action, And Is Not Inconsistent With Federal Policy

The parties here agree that the relevant state's law (if state law is to be applied) is the law of the State of Maryland, because respondent Cash Equivalent Fund, Inc. is

3. Indeed, for example, in *Hart v. General Motors Corp.*, 129 A.D.2d 179, 517 N.Y.S.2d 490 (1st Dep't), *leave to appeal denied*, 70 N.Y.2d 608, 515 N.E.2d 910, 521 N.Y.S.2d 225 (1987), the court noted that a derivative action on behalf of a Delaware corporation had been filed in New York rather than in Delaware precisely because "the outcome in New York may well differ from that in Delaware" on the demand issue. 129 A.D.2d at 186 & n.6, 517 N.Y.S.2d at 495 & n.6.

incorporated in Maryland (Pet. Br. at 11-13; SEC Br. at 18; Resp. Br. at __). Under Maryland law, as is the case under the law of most states, a pre-litigation demand is required in all derivative actions except those in which a shareholder plaintiff can plead facts demonstrating that the role of the corporation's directors (or the alleged domination and control of the directors by alleged wrongdoers) is such that demand would be "futile." *See, e.g.*, *Zimmerman v. Bell*, 585 F. Supp. 512, 514 (D. Md. 1984); *Parish v. Maryland & Va. Milk Producers Ass'n*, 250 Md. 24, 82-83, 242 A.2d 512, 544-45 (1968), *cert. denied*, 404 U.S. 940 (1971). As explained fully in respondent's brief, petitioner's allegations in this case are plainly insufficient to excuse demand under Maryland law (Resp. Br. at __).

Nothing in federal law is inconsistent with the imposition of such a demand requirement. First, Federal Rule 23.1—as outlined above—is a procedural rather than a substantive requirement, and thus does not represent any federal policy other than a need to plead, with particularity, compliance with whatever demand requirement governs a particular action. Second, the Investment Company Act contains no express demand requirement or exception to the demand requirement. *Cf.* 15 U.S.C. § 78p(b) (explicitly legislating a demand requirement for actions under Section 16(b) of the Securities Exchange Act of 1934). This absence in the Investment Company Act of an express demand requirement is particularly significant, because corporation law is an area in which federal statutes do not "authorize the federal courts to fashion a complete body of federal law." *Burks*, 441 U.S. at 477. To the contrary, "in this field congressional legislation is generally enacted against the background of existing state law; Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute." *Id.* at 478.

Moreover, *Burks* makes clear that the Investment Company Act does *not*, as a matter of federal policy, preclude the termination of derivative actions by disinterested

directors pursuant to state law:

> Congress' purpose in structuring the Act as it did is clear. It "was designed to place the unaffiliated directors in the role of "independent watchdogs," who would "furnish an independent check upon the management" of investment companies. . . . Without question, "[t]he function of these provisions with respect to unaffiliated directors [was] to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs." . . .
>
> Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders. *There may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue—as, for example, where the costs of litigation to the corporation outweigh any potential recovery. In such cases, it would certainly be consistent with the Act to allow the independent directors to terminate a suit, even though not frivolous. Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon "watchdogs" to protect shareholder interests and yet, where the "watchdogs" have done precisely that, require that they be totally muzzled.*

Id. at 484-85 (citations and footnotes omitted).

If no federal policy prohibits termination by disinterested directors under state law of shareholder actions brought pursuant to the Investment Company Act, then *a fortiori* no federal policy prohibits states from imposing a requirement that shareholders make a pre-litigation demand prior to filing such a suit, or from excusing that demand where a demand would be "futile" within the meaning of that term under the

particular state's corporate law.[4]

C. If This Court Determines That Federal Law Governs The Demand Issue, Then The Judgment Of The Court Of Appeals Should Be Affirmed On The Opinion Of The District Court, And The Court Of Appeals' Federal "Universal" Demand Requirement Should Be Rejected

If this Court holds that federal law governs the pre-litigation demand requirement in this case, then the Court should affirm the dismissal of this action on the ground relied upon by the district court—petitioner's failure to plead particularized facts demonstrating demand futility under federal law (659 F. Supp. at 1160-63 (Pet. App. 46a-56a); Resp. Br. at __).

This Court should also reject the court of appeals' determination that "the day is at hand" to "dispense[ ] with

4. Petitioner suggests that "state law cannot justify dismissal of the present action" (Pet. Br. at 10), citing *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980), a case holding that the purpose underlying section 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a)—an analogous provision to section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), the provision at issue in this case—would be frustrated "if a director *who was made a defendant* in a derivative action for providing inadequate information in connection with a proxy solicitation were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation." *Id.* at 63 (emphasis added). Here, however, petitioners concede that "in the present case the directors are not themselves defendants" (Pet. Br. at 10). Post-*Galef* decisions in the same Circuit which decided *Galef* have permitted directorial termination in such cases. *See Abramowitz v. Posner*, 672 F.2d 1025, 1031-32 (2d Cir. 1982); *Maldonado v. Flynn*, 671 F.2d 729, 731-32 (2d Cir. 1982).

Even more important, the issue in this case is not whether termination of this action by directors would frustrate federal policy, but whether requiring a pre-litigation demand would frustrate federal policy.

the [futility] exception altogether," and to test claims of demand futility "by *making* the demand rather than arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law, which applies in light of the holding of *Burks*." 908 F.2d at 1346, 1347 (Pet. App. 18a, 20a) (emphasis in original).

The court of appeals' "universal" demand requirement has previously been proposed in the *Model Business Corporation Act* and by the drafters of the American Law Institute's on-going corporate governance project, *Principles of Corporate Governance: Analysis and Recommendations*. *See Model Business Corporation Act* § 7.42, *printed in Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings*, 45 Bus. Law. 1241 (1990); *Principles of Corporate Governance: Analysis and Recommendations* § 7.03 (Tentative Draft Nos. 8 & 9 Apr. 15, 1988 & Apr. 14, 1989).[5] To date, three states—Florida, Georgia and Michigan—have adopted this rule. *See* Fla. Stat. § 607.0740(2); Ga. Code Ann. § 14-2-742; Mich. Comp. Laws Ann. § 450.1493a(a).

The Official Comment to the *Model Business Corporation Act* explains that the rationale underlying a universal demand requirement is two-fold. First, even if a board of directors does not include a majority (or even any) disinterested directors, there is still no reason to deny the board an opportunity "to reexamine the act complained of in the

5. The most recent publicly disseminated draft of the provisions of *Principles of Corporate Governance* dealing with the proposed universal demand requirement and related rules governing shareholder derivative litigation is contained in Tentative Drafts Nos. 8 and 9. These provisions were tentatively approved by the ALI's membership at the Institute's 1988 and 1989 Annual Meetings, subject to further review and reconsideration prior to the completion of the project. The ALI's reporters are now in the process of revising these provisions, and plan to present them to the ALI's membership in 1992.

light of a potential lawsuit and take corrective action." Model Business Corp. Act § 7.42 Official Comment, *printed in Changes in the Model Business Corporation Act*, 45 Bus. Law. at 1244. Second, requiring demand on a universal basis will save litigants and courts the time and expense they would otherwise incur in litigating the demand futility issue. *Id.* The drafters of *Principles of Corporate Governance* similarly emphasize that a universal demand requirement "would eliminate much of the collateral litigation that today slows the pace and increases the cost of derivative litigation," while placing a "relatively costless" burden upon shareholders and possibly "induc[ing] the board to consider issues or take corrective action that either moots or permits the early resolution of the action." Tentative Draft No. 8 § 7.03 comment at 64-65.

The Business Roundtable agrees with the court of appeals and the drafters of the *Model Business Corporation Act* and *Principles of Corporate Governance* that requiring demand in all cases may well produce beneficial corporate governance results. The Business Roundtable also believes, however, that adoption of such a requirement at the federal rather than the state level would be an inappropriate exercise of federal power, for two reasons.

First, a universal demand requirement would conflict with Rule 23.1's express provision that "[t]he complaint shall allege with particularity the efforts, *if any*, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action *or for not making the effort*" (emphasis added). Any reading of Rule 23.1 which permits imposition of a universal demand requirement at the federal level would render the highlighted words mere surplusage, and should thus be rejected. *See, e.g., United States v. Menasche*, 348 U.S. 528, 538-39 (1955) ("'The cardinal principle of statutory construction is to save and not to destroy.' It is our duty 'to give effect, if possible, to every clause and word of a statute,' rather than to emasculate an entire section. . . .")

(citations omitted); 2A *Sutherland Statutes and Statutory Construction* § 46.06 (1984) ("[a] statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant") (footnotes omitted).

Second, and more important, the close relationship between a federal universal demand requirement and the numerous state law issues which would surround such a requirement would plague the federal courts (and litigants in the federal courts) with tremendous uncertainty and confusion. This uncertainty and confusion would far outweigh any benefits that might arise from a universal demand requirement, and militates against the adoption of such a universal demand rule at the federal level.

This point is illustrated by considering the two types of cases in which courts today are typically required to review board decisions either to refuse a shareholder demand or to seek to terminate already commenced derivative litigation, and the means by which demand refusals are dealt with in the *Model Business Corporation Act* and *Principles of Corporate Governance* formulations of the universal demand requirement.

"Demand Required" Cases. It is well settled under Delaware law[6] that a determination to refuse a demand by a

6. "By any measure, Delaware is the preeminent state in corporation law. Over 40 percent of the companies listed on the New York Stock Exchange are incorporated in Delaware. A majority of the publicly traded Fortune 500 companies are Delaware corporations." 1 R. Balotti & J. Finkelstein, *The Delaware Law of Corporations and Business Organizations* F-1 (2d ed. 1990) (footnote omitted).

Courts outside of Delaware also often look to Delaware courts for guidance with corporate law issues, because the Delaware courts have more experience with these issues than courts in other jurisdictions. *See, e.g., Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986) ("Indiana takes its cues in matters of corporation law from the

(continued...)

board consisting of a majority of disinterested directors will be evaluated by the courts just like any other business decision by a board of directors, in accordance with the business judgment rule—"a presumption that in making a business decision, not involving self-interest, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Spiegel v. Buntrock*, 571 A.2d 767, 774 (Del. 1990). *See also, e.g.*, *id.* at 777 ("[I]f the requirements of the business judgment rule are met, the board of directors' decision not to pursue the derivative claim will be respected by the courts. In such cases, a board of directors' motion to dismiss an action filed by a shareholder, whose demand has been rejected, must be granted."); *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 & n.10 (Del. 1981).[7]

"Demand Excused" Cases. Where a majority of a corporation's directors are interested in the subject matter underlying a shareholder grievance and demand is excused, the directors do not have the option of refusing demand. In such a case, however, the board may appoint a "special litigation committee" consisting solely of disinterested directors to determine what action should be taken with

6. (...continued)
Delaware courts"), *rev'd on other grounds*, 481 U.S. 69 (1987); *Detwiler v. Offenbecher*, 728 F. Supp. 103, 147 n.17 (S.D.N.Y. 1989) ("Michigan courts look to Delaware law as a guide for adjudicating matters involving corporate law."); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488, 509 n.29 (Bankr. N.D. Ill. 1988) ("Illinois courts have often looked to Delaware law for guidance in deciding previously undecided corporate law issues.").

7. The law is the same in every jurisdiction which has addressed the issue. *See generally* Block, Radin & Rosenzweig, *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 Bus. Law. 469, 492-97 (1990) (containing state by state survey of the law).

respect to the litigation. *See, e.g.*, *Burks*, 441 U.S. at 473-75, 486. If the committee determines to seek dismissal of the litigation on the ground that prosecution of the action will not serve the best interests of the corporation, the committee's decision is reviewed by the courts pursuant to a stricter level of judicial scrutiny than the business judgment rule.

The Delaware courts, for instance, have developed a two-step test pursuant to which the Delaware Court of Chancery (1) reviews the independence and good faith of the special litigation committee and the bases supporting the committee's conclusion that litigation would not serve the corporation's best interests, with the corporation bearing the burden of proof on these issues, and (2) exercises its own "independent business judgment" concerning the merits of the committee's decision to seek dismissal if the court in its exercise of discretion deems such review appropriate in the particular case. *See, e.g.*, *Kaplan v. Wyatt*, 499 A.2d 1184, 1188 (Del. 1985), *aff'g* 484 A.2d 501, 508-09 (Del. 1984); *Zapata*, 430 A.2d at 788-89.

In New York, by contrast, judicial review of the merits of a special litigation committee's decision to seek dismissal is limited to the independence of the committee's members and the appropriateness and sufficiency of the committee's investigation. Judicial review of the substantive aspects of the decision that litigation would not serve the best interests of the corporation is not permitted. *See Auerbach v. Bennett*, 47 N.Y.2d 619, 633-34, 393 N.E.2d 994, 1002-03, 419 N.Y.S.2d 920, 920-29 (1979).

Other states have adopted even different formulations of the law governing cases in which demand is excused. *See, e.g.*, *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 715-18 (Iowa 1983); *Houle v. Low*, 407 Mass. 810, 812-26, 556 N.E.2d 51, 53-60 (1990); *Alford v. Shaw*, 320 N.C. 465, 467-74, 358 S.E.2d 323, 325-28 (1987), *subsequent proceedings*, 327 N.C. 526, 398 S.E.2d 445 (1990).

The Model Business Corporation Act And Principles Of Corporate Governance Treatment Of Demand Refusals. The *Model Business Corporation Act* adheres to present law by "carry[ing] forward the distinction" between what are currently "demand required" and "demand excused" cases "by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of independent directors." *Model Business Corporation Act* § 7.44 Official Comment, 45 Bus. Law. at 1251. Specifically, in derivative actions filed after refusal of a universal demand and in which the board consists of a majority of disinterested directors, the action "shall be dismissed by the court" unless the shareholder plaintiff alleges particularized facts establishing that the determination to refuse demand was not made by independent directors acting in good faith after conducting a reasonable inquiry. *Model Business Corporation Act* § 7.44. In cases in which a majority of the board does not consist of disinterested directors, however, the burden is upon the corporation to establish that a decision to refuse demand was made in good faith and on the basis of a reasonable inquiry. *Id.*

The most recent draft of *Principles of Corporate Governance* differs from the *Model Business Corporation Act* by providing for independent judicial review of the merits of a board decision not to litigate a particular claim even in cases in which a majority of the corporation's directors *are* disinterested, unless the claim involves a violation of the directorial fiduciary duty of care, as opposed to a violation of the directorial fiduciary duty of loyalty. *See* Tentative Draft Nos. 8 & 9 §§ 7.08, 7.10 & 7.11. As petitioner correctly notes, "virtually all derivative cases" involve allegations of self-dealing (Pet. Br. at 21) and thus violations

of the duty of loyalty.[8]

* * *

Federal courts faced with board refusals of federally mandated universal demands "should apply state law governing the authority of independent directors to discontinue derivative suits," unless the result reached under state law frustrates federal policy. *Burks*, 441 U.S. at 486. Since there is no universal demand requirement in most states (including Delaware), there have been no refusals of universal demands in most states. Barring changes in state law, there will in the future continue to be no refusals of universal demands in most states. Accordingly, unlike most federal court decisions involving state law, the decision regarding what state rule of

8. Both petitioners and the Securities and Exchange Commission oppose adoption of a universal demand requirement on the ground that such a requirement might well "spell the death of all derivative actions" (Pet. Br. at 23), and "have troubling, and, in our view, impermissible, consequences for the enforcement of claims under the Investment Company Act" (SEC Br. at 24). These concerns seem to be based upon petitioner's and the SEC's fear that courts would evaluate all board refusals of universal demands pursuant to the business judgment rule, because that is the standard utilized under current law in cases in which demand is required—*i.e.*, in cases involving corporations having a majority of disinterested directors. As illustrated above, however, neither the *Model Business Corporation Act* nor the *Principles of Corporate Governance* formulations of the universal demand requirement require business judgment rule scrutiny in cases in which a majority of the corporation's directors are not disinterested.

Indeed, far from sounding the death knell for derivative litigation, the current draft of *Principles of Corporate Governance* tilts the pendulum far away from the business judgment rule standard of review pursuant to which petitioners and the SEC fear all decisions to refuse universal demands will be measured against. The *Principles of Corporate Governance* formulation has been sharply criticized on this ground. *See, e.g.*, Block, Radin & Rosenzweig, *supra* note 7, 45 Bus. Law. at 501-07; Dooley & Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law. 503 (1989).

law will govern a refusal of a federally mandated universal demand must be made without the guidance of state court precedents.

Federal courts asked to construe the law of a state such as Delaware following the refusal of a "universal" demand would thus have two choices. First, the court could begin by determining whether a "traditional" demand would have been required or excused under the applicable state's law (exactly the inquiry sought to be avoided by the universal demand requirement), and then apply that state's law to either the "demand required" or "demand excused" scenario at issue. In the alternative, the court could predict whether a particular state—assuming the state were to adopt a universal demand requirement—would follow the *Model Business Corporation Act* or the *Principles of Corporate Governance* approach, or some variation of one of these approaches.[9] Under either of these scenarios, federal courts would be developing state law without the guidance of state court precedents.

These state law issues which will arise in the future, of course, need not—and should not—be decided on the record before this Court, which includes neither a demand nor a refusal of a demand. The existence of these state law issues, however, demonstrates that while there may be much to be said on policy grounds in support of a universal pre-litigation demand requirement, adoption of such a rule *at the federal level* would create a procedural nightmare for the federal

9. Of the three states which have adopted universal demand requirements, two—Florida and Georgia—follow the *Model Business Corporation Act* approach, modified to provide only that a derivative action "may be dismissed" rather than "shall be dismissed" if the *Model Business Corporation Act* criteria have been satisfied. *See* Fla. Stat. § 607.0740(3); Ga. Code Ann. § 14-2-744. The third state—Michigan—follows the Model Act approach, without exception. *See* Mich. Comp. Laws Ann. § 450.1495.

courts. The result will be less predictability and more litigation than is the case under current law—a result which would far outweigh the benefits which might be achieved by adopting a federal universal demand requirement. The Business Roundtable respectfully submits that nothing could more aptly demonstrate the wisdom of leaving the ultimate determination regarding the policy considerations underlying the universal demand doctrine to the states, to be decided—as has been done in Florida, Georgia and Michigan—in conjunction with all related corporate governance issues.

CONCLUSION

For the reasons set forth above, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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Dated: February 19, 1991

(9)

No. 90-516

IN THE
Supreme Court Of The United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC. and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ of Certiorari To The United States
Court of Appeals For The Seventh Circuit

MOTION FOR LEAVE TO FILE BRIEF, AMICUS CURIAE,
and
BRIEF, AMICUS CURIAE,
OF THE INVESTMENT COMPANY INSTITUTE
IN SUPPORT OF RESPONDENTS

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MOTION FOR LEAVE TO FILE BRIEF, AMICUS CURIAE

Pursuant to Rules 21.2(b) and 37.4 of this Court's Rules, the Investment Company Institute (the "Institute") hereby respectfully moves for leave to file the attached brief, *amicus curiae*, in the above-captioned case. The respondents have consented to the filing of such a brief; the petitioner has declined to consent to the filing of this brief.

The Institute is the national association of the American investment company industry. The Institute's membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advisers and principal underwriters and sponsors of unit investment trusts. The Institute regularly engages in legislative and private-sector initiatives relating to the welfare of investment companies and their shareholders, and continually assesses the adequacy of existing protections of investment companies and their shareholders.

The Institute has a substantial interest in this case because of its significance to investment companies. The Institute is concerned that, to the extent a board of directors of an investment company is deprived of the opportunity to consider whether claims should be asserted in the name of the company, this will result in an evisceration of the statutory role of independent investment company directors, to the detriment of investment companies and their shareholders, and will subvert clearly articulated Congressional intent. Leave of this Court is sought to offer the Institute's unique perspective on the proper resolution of the important issues raised by the parties, so that the decision in this case can most effectively be reconciled with the structure and purposes of the Investment Company Act of 1940.

For the foregoing reasons, the Institute should be permitted to file the attached brief, *amicus curiae*.

Respectfully submitted,

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February 19, 1991

QUESTIONS PRESENTED FOR REVIEW

The Investment Company Institute adopts, by reference, the questions presented by the respondent Kemper Financial Services, Inc.

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No. 90-516

IN THE

Supreme Court Of The United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC. and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ of Certiorari To The United States
Court of Appeals For The Seventh Circuit

BRIEF, AMICUS CURIAE,
OF THE INVESTMENT COMPANY INSTITUTE
IN SUPPORT OF RESPONDENTS

The Investment Company Institute (the "Institute") files this brief, *amicus curiae*, in support of the respondents' prayer that the judgment of the United States Court of Appeals for the Seventh Circuit, entered on July 18, 1990, be affirmed.

INTEREST OF THE INVESTMENT COMPANY INSTITUTE

The Institute is the national association of the American investment company industry. The Institute's membership includes open-end investment companies (commonly known as "mutual funds"), closed-end investment companies, investment advisers and principal underwriters and sponsors of unit investment trusts. The Institute regularly engages in legislative and private-sector initiatives relating to the welfare of investment companies and their shareholders, and continually assesses the adequacy of existing protections of invest-

ment companies and their shareholders. The Institute's investment company members are registered with the United States Securities and Exchange Commission (the "Commission" or "SEC") under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1, *et seq.* (the "Act" or "ICA"), and are subject to detailed statutory and regulatory prescriptions regarding their structure, operations and governance.[1]

The Institute has a substantial interest in this case because of its significance to investment companies. The Institute is concerned that, to the extent a board of directors of an investment company is deprived of the opportunity to consider whether claims should be asserted in the name of the company, this will result in an evisceration of the statutory role of independent investment company directors, to the detriment of investment companies and their shareholders, and will subvert clearly articulated Congressional intent.

For the reasons set forth below, the Institute respectfully submits that the decision of the court of appeals should be affirmed, because it is in accordance with well-settled principles of federal law, and because it is consistent with the provisions and policies of the Act.

STATEMENT OF THE CASE

The Institute adopts the statement of the case set forth in the Brief of the Respondent Kemper Financial Services, Inc. ("KFS").

SUMMARY OF ARGUMENT

The Institute believes that the decisions of both the district court and the court of appeals below, holding that the petitioner's Section 20(a) claim should be dismissed for failure to plead facts sufficient under federal law to excuse demand, were correct. A uniform rule, based in federal law, should be applied in considering whether demand should be required in shareholder derivative actions involving investment companies registered under the ICA.

[1] *See, e.g., Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984); *Burks* v. *Lasker*, 441 U.S. 471, 478 (1979).

Moreover, the Institute believes that the decision of the court of appeals, requiring a shareholder demand in all derivative actions raising federal claims, is appropriate as it relates to the potential claims of federally regulated investment companies. In light of the independent director provisions of the ICA, which guarantee the presence of a substantial percentage of directors with no interest in an investment company's adviser and contemplate that such directors should perform a "watchdog" function with respect to shareholder interests, it is appropriate that the Court require that claims should initially be presented to and reviewed by the investment company's board of directors.

Finally, the Commission's argument, as *amicus curiae*, that all Section 20(a) claims are "direct" rather than derivative in nature is not properly before this Court, and is, in any event, contrary to the prior holding of this Court and without merit. The Commission's proposed rule would leave the company, the party which often is the most adversely affected by proxy violations, without a remedy, and would deprive shareholders of the right to bring derivative actions in circumstances where such an action may be the only type of action that is appropriate.

ARGUMENT

I. Both Courts Below were Correct in Concluding that Petitioner Failed Sufficiently to Allege that Demand Would be Futile

Both the district court and the court of appeals held that the allegations of futility in the petitioner's complaint, that the directors of Cash Equivalent Fund, Inc. (the "Fund") (i) received fees for serving on the board, (ii) approved the allegedly misleading proxy statement, and (iii) caused the fund to seek dismissal of the petitioner's suit,[2] were "insufficient to excuse a demand."[3]

In this regard, the decisions of the courts below are firmly rooted in the longstanding rule developed by courts which have considered the parameters of a futility exception, pursuant to which demand will

[2] *See* Pet. App. 6a.

[3] *Id.*

not be excused unless a plaintiff demonstrates, with specific factual allegations, that an antagonism exists between the directors and the corporation to such a degree that it renders the directors incapable of fairly and effectively discharging their duties.[4] The pleadings must indicate that, due to personal bias, interest in a transaction or active participation by the directors in the alleged wrong, the directors are unlikely to act in the best interests of the corporation.[5]

Applying these well-settled principles, both courts below correctly determined that none of the petitioner's allegations suggested that the Board of Directors of the Fund was unlikely to render an informed and disinterested decision as to the petitioner's claim. The petitioner's allegations concerning the directors' remuneration deserve little consideration; nearly every director serving on a board is compensated for his or her services, and such claims are insufficient to establish futility.[6] Moreover, the petitioner's allegations concerning

[4] *See In Re Kauffman Mutual Funds Actions*, 479 F.2d 257, 263 (1st Cir. 1973), *cert. denied*, 414 U.S. 857 (1973). *See also Delaware & Hudson Co.* v. *Albany Susquehanna R.R.*, 213 U.S. 435, 447 (1909); *Gaubert* v. *Federal Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988); *Greenspun* v. *Del. E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980); *Heit* v. *Baird*, 567 F.2d 1157, 1160-62 (1st Cir. 1977); *Kaufman* v. *Kansas Gas & Elec. Co.*, 634 F. Supp. 1573, 1578 (D. Kan. 1986); *In Re Consumers Power Co. Derivative Litig.*, 111 F.R.D. 419, 423-24 (E.D. Mich. 1986); *Seidel* v. *Public Serv. Co.*, 616 F. Supp. 1342, 1351 (D.N.H. 1985); *Reilly Mortgage Group, Inc.* v. *Mount Vernon Sav. & Loan Ass'n*, 568 F. Supp. 1067, 1077 (E.D. Va. 1983); *Stein* v. *Aldrich*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,473, at 92,780 (S.D.N.Y. Jul. 18, 1980); *Meyers* v. *Keeler*, 414 F. Supp. 935, 937 (W.D. Okla. 1976).

Although the possible application of state law in this case was not raised by the petitioner until her reply brief in the court of appeals, and thus is not properly before this Court, Maryland law is fully in accord with this principle. *See Parish* v. *Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 81-84, 242 A.2d 512, 544-45 (1968), *cert. denied*, 404 U.S. 940 (1971), *citing McQuillen* v. *National Cash Register Co.*, 22 F. Supp. 867, 874 (D. Md. 1938). *See also Zimmerman* v. *Bell*, 585 F. Supp. 512, 514 (D. Md. 1984) (futility is established under Maryland and federal law when a "complaint sufficiently alleges that the [director] defendants as a body actively participated in the alleged wrongdoing in order to perpetuate their control over the corporation").

[5] *See, e.g., Starrels* v. *First Nat'l Bank*, 870 F.2d 1168 (7th Cir. 1989); *Lewis* v. *Graves*, 701 F.2d 245 (2d Cir. 1983); *Greenspun*, 634 F.2d 1204.

[6] *See Burt* v. *Danforth*, 742 F. Supp. 1043, 1048 (E.D. Mo. 1990); *In Re E.F. Hutton Banking Practices Litig.*, 634 F. Supp. 265, 271 (S.D.N.Y. 1986); *Grobow* v. *Perot*, 539 A.2d 180, 189 (Del. 1988). *See also Panter* v. *Marshall Field & Co.*, 646 F.2d 271, 294 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981) (directors found independent since "they derived no income from Field's other than normal directors' fees").

the directors' "approval" of the dissemination of the Fund's 1984 proxy statement are similarly unconvincing, since acts complained of by a shareholder in a derivative suit will often carry some measure of prior approval, tacit or explicit, of the company's board of directors.[7] Courts have consistently rejected these claims,[8] as well as claims of futility based on boilerplate allegations that demand is tantamount to asking the directors to "sue themselves."[9] Finally, a corporation's defense of a derivative suit which was not preceded by a demand has likewise been determined not to excuse demand, principally because such defense does not, by itself, mean that the board would have failed to consider a demand in accordance with its fiduciary duties.[10]

The Commission, as *amicus curiae*, contends that state (*i.e.*, Maryland) law should be applied to determine whether demand should have been excused in this case, on the theory that matters of demand and futility concern the "substantive law of corporations." Commission Br. 16. The Institute believes, to the contrary, that federal law should govern questions relating to the demand requirement in cases brought in federal courts, at least where, as here, the claims are based on the ICA.[11] While lower courts have not always been clear as to

[7] *See In Re Kauffman Mutual Funds Actions*, 479 F.2d at 265; *Kaufman* v. *Kansas Gas & Elec. Co.*, 634 F. Supp. at 1580.

[8] *See, e.g., Cottle* v. *Hilton Hotels Corp.*, 635 F. Supp. 1094, 1098 (N.D. Ill. 1986); *Gaubert* v. *Federal Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988); *Brickman* v. *Tyco Toys, Inc.*, 722 F. Supp. 1054 (S.D.N.Y. 1989); *Recchion* v. *Kirby*, 637 F. Supp. 1309, 1320 (W.D. Pa. 1986).

[9] *See, e.g., Lewis* v. *Graves*, 701 F.2d at 249; *Lewis* v. *Curtis*, 671 F.2d 779, 785 (3d Cir. 1982), *cert. denied*, 459 U.S. 880 (1982); *Cottle*, 635 F. Supp. at 1098; *Recchion*, 637 F. Supp. at 1320; *Pullman-Peabody Co.* v. *Joy Mfg. Co.*, 662 F. Supp. 32, 35 (D.N.J. 1986). *See also Zimmerman*, 585 F. Supp. at 514 (holding that under both Maryland and federal law, "merely naming the directors is not enough to establish that a demand would be futile").

[10] *See Gartenberg* v. *Merrill Lynch Asset Management*, 91 F.R.D. 524, 527 (S.D.N.Y. 1981); *Grossman* v. *Johnson*, 89 F.R.D. 656, 659 (D. Mass. 1981), *aff'd*, 674 F.2d 115 (1st Cir. 1982), *cert. denied*, 459 U.S. 838 (1982).

[11] The Commission relies on *Burks* for the proposition that demand and futility concern the "substantive law of corporations" and, accordingly, should be governed

which law they were applying, federal courts have often remarked that the record would not support a finding of futility under either state or federal law, thus noting the existence of a separate body of federal law on this issue.[12] Likewise, in this case, Maryland law is in accord with the federal common law applied by both courts below,[13] and recog-

by state law. Yet, ***Burks*** concerned the power of disinterested directors of an investment company to terminate derivative litigation, and thus concerned the "font of corporate directors' powers," ***Burks***, 441 U.S. at 478, including the sustainability of the board's action under a substantive standard -- the business judgment rule and its various permutations — that implicates core principles of corporate law that historically have been determined under state law. Federal law does not provide comprehensive legal standards in this area; instead, "federal law * * * is largely prohibitory in nature — it often limits the exercise of directorial power, but only rarely creates it." ***Burks***, 441 U.S. at 478.

By contrast, the futility exception is first and foremost a matter of the adequacy of the pleadings that principally relates to procedure. *See Meltzer* v. *Atlantic Research Corp.*, 330 F.2d 946, 948-49 (4th Cir. 1964), *cert. denied*, 379 U.S. 841 (1964). And unlike ***Burks***, demand and futility are matters on which federal law provides an impressive history and comprehensive standards. Indeed, when this Court enforced a demand requirement in ***Hawes*** v. ***Oakland***, 104 U.S. 450 (1881), it derived the requirement from considerations of federal law and policy. Thus, while the demand rule may have evolved out of the general proposition that, under state law, a corporation is managed by its board of directors, it has other historical antecedents and contemporary functions.

[12] *See, e.g.*, ***Gaubert***, 863 F.2d at 64; ***Meltzer***, 330 F.2d at 948-49.

[13] *See **Zimmerman***, 585 F. Supp. at 514. The U.S. District Court for the Eastern District of Missouri has suggested that Maryland law is more liberal with respect to the recognition of a futility exception than federal law. *See **Danforth***, 742 F. Supp. at 1047-49. The court stated that Maryland law finds demand futile "[w]hen the directors' prosecution of a plaintiff's claims would result in the directors' prosecuting themselves." *Id.* at 1047. However, it appears that the district court misread Maryland precedent; the cases cited by the ***Danforth*** court clearly require that the defendant directors be accused of fraud or other active participation in a transaction solely to further the individual interests of the directors. *See, e.g.*, ***Parish***, 242 A.2d at 545; ***Eisler*** v. ***Eastern States Corp.***, 182 Md. 329, 35 A.2d 118, 119 (1943). Thus, under Maryland law, demand will not be excused merely because the directors have been named as defendants; a plaintiff must also allege that the directors committed fraud or intentionally breached their fiduciary duties.

In any event, this is not a case in which the directors would have been required to "sue themselves." The petitioner herself has not sued the directors, but seeks recovery only against the adviser to the respondent mutual fund, an entity unaffiliated with a substantial majority of the fund's Board members. Indeed, Section 36(b)(3) of the Act precludes an action for damages against the members of the fund's board.

nizes futility only when fraud or an intentional breach of fiduciary duty by the directors has been alleged with particularity.[14] Fairly read, the complaint contains no such allegations. Accordingly, as explained below, while the Institute is of the view that a uniform federal law of demand is essential in the case of investment companies,[15] Maryland law, even if it applied, would not have changed the result reached by the lower courts.

II. The Court of Appeals' Enforcement of the Demand Requirement is Particularly Appropriate in Derivative Suits Involving Investment Companies

The Institute submits that the decision of the court of appeals requiring shareholder demand in all derivative actions concerning federal claims is firmly supported by the numerous policy considerations articulated by respondent KFS and should be affirmed. In addition, the Institute believes that, for the reasons set forth below, the decision is particularly appropriate as it relates to registered investment companies, and should govern all shareholder derivative actions which assert claims involving investment companies.

Investment companies are extensively regulated by the Commission under the ICA, in order "to eliminate [] conditions which adversely affect * * * the interest of investors."[16] A principal statutory provision enacted to accomplish that goal is a requirement that at least 40 percent of an investment company's board of directors be composed of independent outside directors, that is, directors who are not

[14] *See, e.g.*, ***Parish***, 242 A.2d 512; ***Rosengarten*** v. ***Buckley***, 565 F. Supp. 193 (D. Md. 1982); ***Oldfield*** v. ***Alston***, 77 F.R.D. 735 (N.D. Ga. 1978); ***Danforth***, 742 F. Supp. 1043.

[15] *See* Part II, *infra*.

[16] 15 U.S.C. § 80a-1 (1988). It should be noted that the Commission has, in other contexts, successfully argued before this Court that its extensive regulatory oversight is an important consideration which should be taken into account in determining the parameters of private actions under the securities laws. *See **Shearson/American Express, Inc.*** v. ***McMahon***, 482 U.S. 220, 233-39 (1987) (Commission successfully argued that its extensive regulatory oversight of self-regulatory organizations and their arbitration procedures was adequate to ensure full vindication of the rights of investors in arbitration proceedings). Here, however, the Commission fails to give effect to the fact that it oversees the effectuation of the ICA's independent director provisions.

interested in the company's investment adviser.[17] The Act further requires that a majority of an investment company's board be independent of the investment company's principal underwriter.[18] Since most investment companies employ underwriters that are the same or related to the investment adviser, the Act effectively insures that, in most cases, the independent members of investment companies' Boards constitute a majority of the board of directors.[19] This is the case with the Fund, whose principal underwriter is a KFS affiliate. J.A. 40.

Congress delegated certain special functions to the independent directors, in the sensitive areas of management contracts and financial reporting, in order to protect shareholders from potential abuse of the relationship between investment companies and their advisers.[20] Thus, the independent directors are required to approve the contracts between the investment company and its investment adviser and principal underwriter,[21] to fill vacant independent director positions that occur as a result of an assignment of advisory contracts,[22] and to

[17] 15 U.S.C. §§ 80a-15(a) & 80a-2(19) (1988). *See Burks*, 441 U.S. at 482 ("The cornerstone of the ICA's effort to control conflicts of interest within mutual funds is the requirement that at least 40% of a fund's board be composed of independent outside directors").

[18] *See* 15 U.S.C. § 80a-10(b)(2) (1988). *See also* S. Rep. No. 1775, 76th Cong., 3d Sess. 14 (1940) ("[A] majority of the board of directors of an investment company must be composed of persons who are not * * * principal underwriters of its securities * * * [or] persons affiliated with them."); S. Rep. No. 184, 91st Cong., 1st Sess. 4, *reprinted in* 1970 U.S. Code Cong. & Admin. News 4897, 4901 [hereinafter S. Rep. No. 184] ("Included in this act was a requirement * * * that a majority of the fund's directors be unaffiliated with the fund's principal underwriter.").

[19] *See* S. Rep. No. 184, *supra* note 18, at 4901 ("Since the adviser and underwriter are usually the same or related entities, a majority of the directors of most funds are unaffiliated with their managers.").

[20] *See, e.g., id.* ("Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser.").

[21] *See* 15 U.S.C. § 80a-15(c) (1988).

[22] *See id.* § 80a-16(b). The assignment of advisory contracts gives rise to vacancies because the Act requires that in the three years following such transfer, at least 75 percent of the investment company's board must be independent of the new investment adviser and its predecessor. *See id.* § 80a-15(f)(1)(A). Directors who are

select the independent auditor who certifies or signs the investment company's financial statements.[23]

The legislative history of the Act further emphasizes the importance that Congress ascribed to the role of the independent directors of investment companies in protecting shareholder interests. The Chief Counsel for the Study of Investment Trusts and Investment Companies (which was undertaken by the Commission prior to the enactment of the ICA) stated in his testimony that "[i]n order to furnish an independent check upon the management, the provision is made that at least 40 percent of the board must be independent of the management, officers and employees. * * * [T]hat is one of the most salutary provisions in this bill."[24] Consistent with this view, Congress rejected a proposal of the SEC that "would have forced investment companies to seek court approval before settling claims against 'insiders' that could be the target of derivative suits."[25]

When Congress reconsidered the adequacy of the Act's protection of investors in connection with the 1970 amendments to the Act, "Congress consciously chose to address the conflict-of-interest problem through the Act's independent directors section, rather than

independent at the time of the transfer (and who remain independent after the transfer) will fill any position vacated by interested directors constituting more than 25 percent of the board. *See id.* § 80a-16(b).

[23] *See id.* § 80a-32(a). Commission regulations under the Act further emphasize the primary role of independent directors in protecting shareholders against conflict-of-interest transactions. These regulations require, *inter alia*, that independent directors approve, and review at least annually, procedures governing (i) a mutual fund's purchases of securities from an underwriting syndicate which includes an affiliate, (ii) purchase and sale transactions between affiliated mutual funds, and (iii) brokerage transactions with affiliates. The Commission further requires that the independent directors determine compliance with such procedures on a quarterly basis. *See* 17 C.F.R. §§ 270.10f-3, 17a-7 and 17e-1 (1990). Any payments made by a mutual fund in connection with a distribution of its securities must similarly be made pursuant to a plan that is approved by the independent directors and that is terminable by those directors. 17 C.F.R. § 270.12b-1 (1990).

[24] *Investment Trusts and Investment Companies, Hearings on H.R. 10065 Before the Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940) (statement of David Schenker, Chief Counsel, Investment Trust Study, SEC).

[25] *Burks*, 441 U.S. at 484.

through more drastic remedies such as complete disaffiliation of the companies from their advisers or compulsory internalization of management functions."[26] At that time, Congress strengthened the independence of directors by requiring directors to meet the stricter standard of disinterest in a variety of respects,[27] rather than by the sole requirement that they not be affiliated with the fund's adviser.[28] Congress thus determined that the independent director provisions could be used effectively to insure that such directors fulfilled their duty to "supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs."[29]

The role of independent directors in protecting investment company shareholders was noted by this Court in *Burks*, 441 U.S. 471, in which the Court stated: "Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interest of the funds' shareholders."[30] The Court observed that the special functions assigned to the independent directors of mutual funds indicate the confidence of Congress in the directors' abilities to protect shareholders from conflicts of interest with the fund's investment adviser.[31] The Court thus concluded that the independent directors occupy the role of "watchdogs" to "'furnish an independent check upon the management' of investment companies."[32]

[26] *Burks*, 441 U.S. at 483; *see also Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 147 (1966).

[27] *See* 15 U.S.C. § 80a-2(19) (1988); *cf.* 54 Stat. 806.

[28] *See id.* § 80a-2(3). *See generally* S. Rep. No. 184, *supra* note 18, at 4927-28 (discussing the addition of the disinterest standard to the Act.).

[29] S. Rep. No. 184, *supra* note 18, at 4927.

[30] *Burks*, 441 U.S. at 485.

[31] "Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the * * * view that such directors could never be 'disinterested' where their codirectors or investment advisers were concerned." *Id.* at 485 n.15.

[32] *Id.* at 484; *see also Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977), *cert. denied*, 434 U.S. 934 (1977) (independent director provision "designed to place the unaffiliated directors in the role of 'independent watchdogs' who would assure that * * * mutual funds would operate in the interest of all classes of their securities holders, rather than for the benefit of investment advisers, directors, or other special groups.").

Other provisions of the Act in no way reduce the significance of the independent directors as the persons charged with primary responsibility for protecting shareholder interests. Although Congress granted shareholders and the Commission the right to bring suit directly for excessive advisory fees under Section 36(b),[33] this right is narrowly circumscribed;[34] it was designed to redress a specific wrong and to supplement the role of the independent directors in a narrow area where Congress determined that such supplementation was appropriate.[35] In fact, Congress engaged in extensive deliberation over the appropriate formulation of Section 36(b) precisely in order to accommodate traditional principles of corporate governance.[36] The extra protections added by Congress in Section 36(b) were in no way intended to detract from the authority of independent directors under the Act or under traditional corporate law principles.[37]

The paramount role that Congress has mandated for independent directors in protecting the interests of investment company shareholders would be given effect by requiring that shareholder derivative actions against an investment company be subject to a uniform requirement of prior demand upon the company's board of

[33] *See* 15 U.S.C. § 80a-36(b) (1988).

[34] *See* Part III, *infra*.

[35] *See Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536-41 (1984).

[36] Congress rejected a suggestion by the SEC that fees be tested under a reasonableness standard because this would put the federal government in the role of fee-setter and "supersede the actions of the management, the board of directors, and the shareholders of the business." 115 Cong. Rec. S13,693 (daily ed. May 26, 1969) (statement of Sen. Bennett). In settling upon the language of Section 36(b), Congress thus wanted it to be understood that "[Section 36(b) was] not designed to ignore concepts developed by the courts as to the authority and responsibility of directors," S. Rep. No. 184, *supra* note 18, at 4903.

[37] Indeed, even with respect to litigation under Section 36(b) itself, Congress sought to preserve much of the deference normally accorded directors' decisions by stating that Section 36(b) "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees," and that "approval of the management fee by the directors * * * is to be given such weight as the court deems appropriate." S. Rep. No. 184, *supra* note 18, at 4902-03.

directors. Under the statutory scheme provided, such demands would be considered by a statutorily mandated group of directors who are "disinterested" under the Act, and who are charged with primary responsibility for protecting shareholder interests. Such directors must be presumed to be capable of acting upon a shareholder demand.

The "futility" exception to the demand requirement is at odds with the structure and requirements of the ICA. The fundamental premise of this exception is the existence of a board of directors which, for reasons of self-interest, bias or other disability, is deemed by law to be inadequate or incapable of making an independent and unbiased decision as to whether to initiate suit. This premise necessarily fails in the case of the Section 20(a) claims at issue here involving the relationship between a registered investment company and its adviser. To be consistent with Congressional purpose and policy, it is appropriate that such claims should be presented to and reviewed by the independent directors.

Moreover, allowing the demand requirement in derivative actions brought against investment companies to be circumvented under various state law futility exceptions — several of which have been read as broadly construing "futility" to obtain on a remarkably meager showing[38] would violate the rule articulated by this Court in *Burks* v. *Lasker*, 441 U.S. 471, 479 (1979), that state law may not be applied to federal claims under the ICA where its application would be inconsistent with the federal policy of the ICA. The ICA clearly embodies a federal policy that the independent directors protect

[38] *See Gaubert*, 863 F.2d at 65 (noting that "some courts have used language that reflects acceptance of * * * less rigorous standard for demand futility."); *Rosengarten*, 565 F. Supp. at 197 ("Courts of different states have reached varying conclusions on the question whether a shareholder suing in the place of the corporation must exhaust his internal remedies if fraud by the corporate directors forms the basis of his complaint."); *In re Consumers Power Co. Derivative Litig.*, 111 F.R.D. 419, 423 (E.D. Mich. 1986) (noting that Delaware law allows plaintiffs to establish futility by alleging *either* a breach of the duty of loyalty *or* a breach of the duty of care, while federal courts apply a "stricter standard" requiring a plaintiff to establish a breach of duty of loyalty); *Zilker* v. *Klein*, 510 F. Supp. 1070, 1073 (N.D. Ill. 1981) ("Courts have not been uniform in their approach to the question whether a demand should be excused * * * [some] courts [ ] have accepted just the bare allegation that demand would be futile.").

shareholder interests in investment companies.[39] When allegations of futility can, in effect, prevent directors from making determinations as to the appropriate disposition of a corporate claim, the directors are rendered unable to fulfill their statutory function. Surely Congress did not intend such a result; indeed, "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet require that they be totally muzzled," without being given an opportunity to do precisely that.[40]

The demand requirement enforced by the court of appeals would, in the case of investment companies, foster the clearly articulated purpose of the Act, the protection of investment company shareholders, and promote uniformity in the Act's administration, a goal which the Commission has, in other contexts, attempted to promote.[41] Congress has unequivocally determined that the independent directors should be the primary protectors of shareholder interests because they are likely to prove the most effective protectors, not only on account of their statutory duties, but also because of their superior knowledge of the relevant facts and the resources of the corporation at their disposal. Demand should thus be required in order to provide the independent directors with an opportunity to assess the appropriate corporate response regarding potential corporate claims.[42]

III. Petitioner has not Stated a "Direct" Section 20(a) Claim

The Commission's use of this case as an opportunity to suggest a radical change in the jurisprudence of proxy claims — that such claims may be asserted only as "direct" claims of shareholders and never as derivative claims — is unfortunate. The Commission ignores the history of the case before it and attempts to reformulate, as a

[39] *See supra* notes 17-37 and accompanying text.

[40] *Burks*, 441 U.S. at 485.

[41] *See* Brief for the Securities and Exchange Commission as Amicus Curiae at 15, *Lampf Pleva Lipkind Prupis & Petigrow* v. *Gilbertson*, 111 S. Ct. 242 (1990) (No. 90-333) ("The securities laws are built around a jurisdictional nexus to interstate commerce or the mails, and were enacted in part because no single State's laws are capable of regulating the Nation's capital markets.").

[42] As the respondent KFS and the Commission agree, issues relating to the standard of judicial review following any rejection of a shareholder demand are not raised here and need not be decided.

"direct" action, a case which was labelled a "derivative" case by the petitioner and pursued as a derivative action in both the district court and the court of appeals.

The Commission's curious proposition is that Section 20(a) claims (and claims under Section 14(a) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78n(a)) are, by definition, *always* direct claims and *never* derivative claims, since, the Commission alleges, these sections do not afford any rights to corporations. This proposition, however, was never asserted by any party to this case over its extended course in the courts below. The court of appeals' notice of the issue[43] does not, in our view, constitute an adequate predicate on which to base a rule of decision in this case, and would deny the parties to this case the opportunity to litigate an issue which belatedly is suggested to constitute the "antecedent" rule of decision.

The Institute submits that the Commission's novel contention is not properly before this Court and, accordingly, should not be considered. However, should the Court conclude to the contrary, the Institute wishes to point out two separate but related problems with the Commission's position. First, with respect to its underlying premise, a "direct" action for damages under Section 20(a), based on the petitioner's allegations, is preempted by Section 36(b). Second, the Commission's reading of the relevant cases to preclude derivative actions for alleged proxy violations is erroneous.

A. Section 36(b) Provides the Exclusive Remedy for Claims Based on Breaches of Fiduciary Duty Respecting Compensation to Advisers

The very nature of the petitioner's proxy claim in this case demonstrates that the Commission's position, that proxy claims are always direct and never derivative, is untenable. The petitioner's proxy claim is based upon a single allegedly misleading statement included in the Fund's 1984 proxy statement relating to the relative amount of fees KFS charged to the Fund. The petitioner did not claim any injury due to the alleged misstatement, and no injury other than on account of the allegedly excessive fees charged to the Fund; she sought no remedy other than a return of such allegedly excessive fees to the Fund. In short, the petitioner's claim under Section 20(a) seeks

[43] Pet. App. 6a-7a.

the precise redress sought in the petitioner's other claim under Section 36(b).

Following the enactment of Section 36(b) of the Act in 1970, however, several courts have ruled that no implied cause of action may be brought under Section 20(a) when such claims relate to excessive fees which may be challenged under Section 36(b).[44] The rationale for this rule is apparent: to allow shareholders to bring excessive fee claims under Section 20(a) would thwart Congressional intent by permitting claimants to erode the procedural and substantive limitations Congress placed in Section 36(b) merely by recasting their claims as violations of Section 20(a).[45]

Prior to the district court's ruling on this issue, only one federal district court had rejected the reasoning of these decisions; that case, however, involved distinct proxy violations which were alleged to have caused distinct harm and where the relief sought encompassed more than return of excessive fees.[46] Although the district court below determined that the petitioner had established a separate Section 20(a) claim, it is submitted that the district court's ruling on this point was erroneous. Allowing a Section 20(a) claim to go forward on the basis

[44] *See Tarlov* v. *Paine Webber Cashfund, Inc.*, 559 F. Supp. 429, 439 (D. Conn. 1983) (holding that "[t]here is no express or implied right of action [under Section 20(a) of the Act] where the alleged violation concerns excessive advisors fees," since "Section 36(b) provides the exclusive method of attacking such fees"); *Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982) (noting in dictum that Section 36(b) may constitute a shareholder's exclusive remedy for excessive fee claims); *Gartenberg* v. *Merrill Lynch Asset Management*, 528 F. Supp. 1038, 1067 (S.D.N.Y. 1981), *aff'd*, 694 F.2d 923 (1982), *cert. denied*, 461 U.S. 906 (1983) (same). *But see Krinsk* v. *Fund Asset Management*, 654 F. Supp. 1227 (S.D.N.Y. 1987), *aff'd*, 875 F.2d 404 (2d Cir. 1989), *cert. denied*, 110 S. Ct. 281 (1989).

[45] *See, e.g.*, *Tarlov*, 559 F. Supp. at 436-39. Congress has thus indicated the manner in which investment company shareholders may recover excessive investment adviser fees on behalf of the investment company.

[46] *Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.*, 622 F. Supp. 169 (S.D.N.Y. 1985) (holding that since the plaintiff alleged "distinct factual allegations of material nondisclosures in particular proxy statements, and seeks legal and equitable relief beyond the mere recapture of excessive fees," such a claim was not "*solely* a breach of fiduciary duty arising from excessive compensation paid to an investment adviser" and, accordingly, could properly be maintained). The district court below applied the reasoning of the *Schuyt* decision, even though the relief sought by the petitioner herein was limited to the return of allegedly excessive fees. Pet. App. 40a-42a.

of the allegations of this case, where no distinct harm was alleged and no remedy, apart from the remedy afforded under Section 36(b), was sought, could result in *all* Section 36(b) claims being brought with related proxy claims, in order to circumvent the procedural rules and substantive limitations imposed by Congress on Section 36(b) actions.

B. If Petitioner's Allegations Could be Construed to State a Section 20(a) Cause of Action, it is Derivative in Nature

The Commission's position that proxy claims may not be derivative is squarely at odds with *J.I. Case Co.* v. *Borak*, 377 U.S. 426 (1964). There, the Court stated:

> The injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done the corporation, rather than from damage inflicted directly upon the stockholder. The damage suffered results not from the deceit practiced on him alone but rather from the deceit practiced on the stockholders as a group. To hold that derivative actions are not within the sweep of the action would therefore be tantamount to a denial of private relief.[47]

Despite the Commission's assertions to the contrary (Commission Br. 15 n.9), in *Borak*, this Court clearly recognized the fundamental difference between derivative and direct causes of action.[48] In fact, the Court's discussion of derivative actions recognized the derivative nature of the claim and was in response to the argument of the petitioner in that case that a private right of action under Section 14(a) "would not extend to derivative suits," 377 U.S. at 431. The Court rejected this contention and, in indicating that the denial of a derivative claim would be the equivalent of a denial of relief, emphasized that a derivative action was the principal type of claim that a plaintiff could assert under Section 14(a).

The Commission's reliance on *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1986), is similarly misplaced. *Fox* concerned only "the unusual cause of action created by § 36(b)," 464 U.S. at 535, which, like the cause of action granted to stockholders under Section 16(b)

[47] 377 U.S. at 432.

[48] 377 U.S. at 431.

of the Exchange Act, is unusual in that it expressly provides that a shareholder may assert a claim that is indisputably a corporate claim, without resorting to a derivative action. It in no way supports the assertion that Section 20(a) claims (assuming the existence of a cause of action under this provision) may not be brought by a corporation.[49]

The Commission has also ignored completely *Studebaker Corp.* v. *Gittlin*, 360 F.2d 692 (2d Cir. 1966),[50] which held that a corporation has standing to assert proxy claims under Section 14(a) of the Exchange Act. The *Studebaker* decision has been followed virtually without question;[51] it and its progeny are firmly grounded in this Court's decision in *Borak*. As noted by Judge Friendly in *Studebaker*, 360 F.2d at 695, "[i]f § 27 of the Securities Exchange Act authorizes a stockholder to assert such a claim on the corporation's behalf, as held in *Borak*, it must also authorize the corporation to do so on its own." Thus, actions seeking the dissemination of correct information in proxy materials are generally actions that affect all shareholders and are derivative in nature.

Whether Section 20(a) of the ICA (or Section 14(a) of the Exchange Act) may, in some circumstances, support a direct shareholder action for damages is an issue not presented by this case,

[49] The Commission also argues that in *Piper* v. *Chris-Craft Indus.*, 430 U.S. 1, 32 n.21 (1977), this Court "made clear that the cause of action recognized in *Borak* flows from the violation of all of the shareholders' rights." Commission Br. 14. The cited passage, however, refuted the proposition that, under the circumstances there present and the relevant Supreme Court standards, Section 14(a) would not be found to give rise to an implied right of action. At most, the Court pointed out that the principal beneficiaries of Section 14(a) are "the stockholders as a group"; it in no way stated that corporations do not have the right to protect the rights of "the stockholders as a group" under Section 14(a), just as companies may act to protect other group rights of stockholders.

[50] *Studebaker* overruled *Howard* v. *Furst*, 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957), which had determined that Section 14(a) of the Exchange Act did not create "any rights whatever in a corporation whose stockholders may be solicited by proxy statements prepared in contravention of the statutory mandate." 238 F.2d at 793. As noted by Judge Friendly, the *Howard* decision was roundly criticized. *See Studebaker*, 360 F.2d at 695 (citing 2 Loss, Securities Regulation 949-50 (1961), and other authorities).

[51] *See, e.g., Airborne Freight Corp.* v. *McPherson*, 427 F.2d 1283, 1286 (9th Cir. 1970); *General Time Corp.* v. *Talley Indus.*, 403 F.2d 159, 161 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

since, as we have shown, the petitioner's damages claim is governed by Section 36(b). Adoption of the Commission's position, however, would be contrary to lower court cases which have permitted actions by corporations to correct misstatements in proxy materials which were disseminated to the detriment of the corporation itself, and all of its shareholders.[52] Rather than promoting the salutary objective of reducing the obstacles to vindication of the interests protected by the law relating to proxy solicitations, the Commission's position would have the opposite effect. By denying to a corporation the standing to bring such claims, the Commission would leave the party which oftentimes suffers substantial harm on account of proxy violations completely without remedy.[53] The Commission's rule ironically would thus deprive shareholders of the right to bring derivative actions, seeking relief that would benefit the corporation, in circumstances where such an action is appropriate.

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[52] *See, e.g., Ameribanc Investors Group* v. *Zwart*, 706 F. Supp. 1248 (E.D. Va. 1989); *Pantry Pride, Inc.* v. *Rooney*, 598 F. Supp. 891 (S.D.N.Y. 1984); *Plant Indus.* v. *Bergman*, 499 F. Supp. 376 (S.D.N.Y. 1980); *Management Assistance, Inc.* v. *Edelman*, 584 F. Supp. 1016 (S.D.N.Y. 1984); *National Home Prod., Inc.* v. *Gray*, 416 F. Supp. 1293 (D. Del. 1976).

[53] In this regard, the Commission's assertion that corporations may adequately protect their interests by intervening "as a party under the customary standards for intervention," is without substance. The Commission's position would prohibit corporations from initiating proxy claims, and would reduce the role of the corporation — the party which often is in the best position vigorously to vindicate claims of proxy fraud — to that of merely a nominally interested party.

CONCLUSION

For all of the foregoing reasons, the judgment of the court below, affirming the dismissal of the petitioner's Section 20(a) claim, should be affirmed.

Respectfully submitted,

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